S. Hrg. 103-279, Pt. 2

THE 1993 ECONOMIC REPORT OF THE PRESIDENT

ARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

PART 2

February 12 and 22, 1993

Printed for the use of the Joint Economic Committee

83-911

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[Created pursuant to Sec. 5(a) of Public Law 304, 79th Congress]

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THE 1993 ECONOMIC REPORT OF THE PRESIDENT: INVESTING IN CAPITAL TECHNOLOGY AND INFRASTRUCTURE

Friday, February 12, 1993

Congress of the United States,
Joint Economic Committee,
Washington, DC.

The Committee met, pursuant to notice, at 10:00 a.m., in room 2359, Rayburn House Office Building, Honorable David R. Obey (Chairman of the Committee) presiding.

Present: Representative Obey.

Also present: William Buechner, professional staff member.

OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

Representative Obey. Good morning.

We only have one witness at the table at the moment, but I understand Dr. Chimerine is on the way. Unfortunately, Larry Kudlow, who was to be with us this morning, has been stuck in an airplane in New York and is experiencing the pleasures of airline travel this morning rather than being with us, and we are sorry about that. I certainly understand. I have been stuck that way many times myself.

This morning, the Joint Economic Committee is concluding a series of three hearings that we have undertaken this week in order to examine the current state of the American economy and to try and walk through, in a very brief way, some of the challenges which face President Clinton as he makes his choices about budget and economic policy, and of course the challenges that will also be facing the Congress.

Yesterday morning in our first hearing, we had two distinguished Nobel Laureates, Professor James Tobin of Yale and Professor Robert Solow of Massachusetts Institute of Technology, who focused on the question of how to reverse the anemic economic growth and the absence of measurable job growth during the past 22 months.

Professor Solow used a medical analogy to describe the need to boost the economy now, before attacking the budget deficit. He likened the current situation to a patient in need of surgery. The doctor wants to schedule surgery, but first he wants to make sure that the patient is strong enough to withstand the trauma.

The economy right now is too weak for the contractionary effects of deficit reduction. Before we operate, we need to make sure the economy is strong enough to withstand the surgery. That was his view.

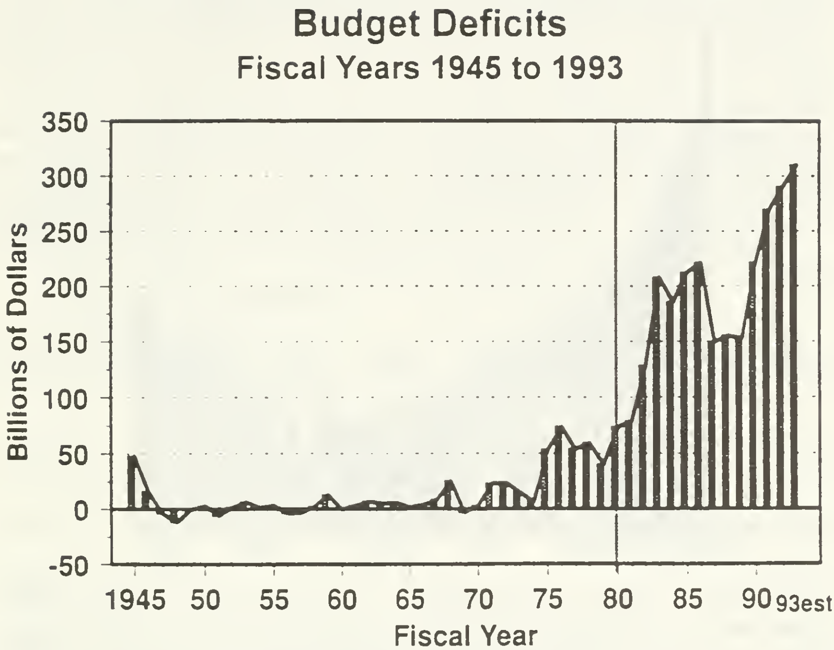
Allan Meltzer of Carnegie Mellon, who did not argue for stimulus now, told us that the budget deficit is not as much of a problem as has been widely repeated. He said that if we had incurred the same deficits we incurred in the 1980s but used that money for productive investment, we would be much richer and have higher standards of living than we have now. He said that as we focus on our long-term economic needs, we ought to bear in mind that we cannot get the kind of long-term growth we want without making the right kinds of investments.

The afternoon session focused on what those investments should be. Our panel focused on programs that invest in people and pointed out that much needs to be done to correct the very serious deficiencies in this country's job training and antipoverty programs.

This morning, we want to focus our attention on what ought to be done to increase investment in physical capital by both the public and private sectors, and we will also be discussing some of the macroeconomic issues which we were discussing yesterday.

Before we do that, I would like to do something which I did yesterday in order to open the first hearing, and I apologize to any of you in the room who were here. I also apologize to anyone who may eventually be watching this on C-SPAN, because I did much the same thing yesterday, but I think it is important to do it as often as possible to emphasize the fact that we are not just facing one problem, we are facing, in my view, four problems. I think we are facing four deficits, the most serious of which is what is traditionally understood to be the federal budget deficit.

If you take a look at this chart, it demonstrates that in raw dollar terms up until 1980, we never had a deficit that exceeded $74 billion dollars. (See chart below.) I told the audience yesterday that I can recall sitting in Senator Byrd's office in 1980 when Jimmy Carter was President and Paul Volcker was in the room with us. We had a bunch of political leaders in both Houses, and Senator Byrd sat in the room telling us that if we didn't cut $16 billion out of the deficit, we would hit a deficit that year of $60 billion, and the country couldn't handle it. So we cut $16 billion. We went around the table making cuts in everybody's favorite programs except, unfortunately, at that point, the Pentagon's. So we cut $16 billion worth of spending, but the deficit did not go down because the economy moved.



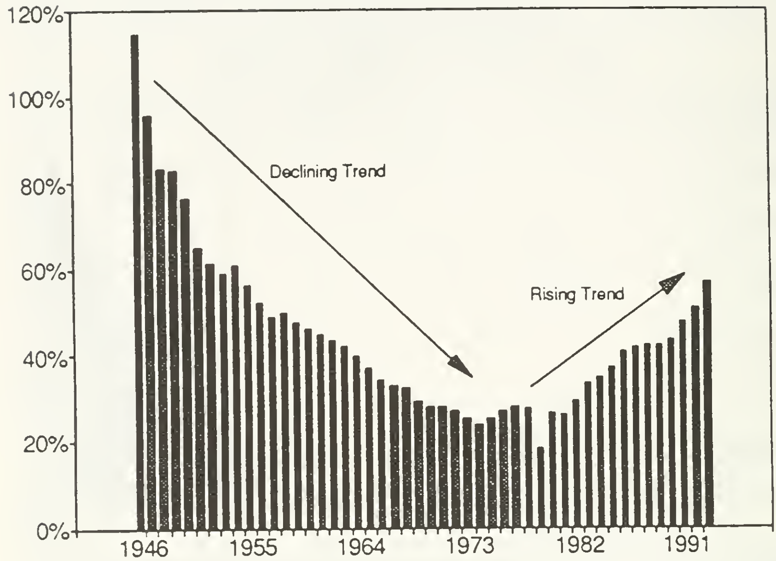
Source: Office of Management & Budget; Congressional Budget Office

The economy sagged and so in fact the deficit went up slightly. Then in came President Reagan and he told the Congress that if we passed his package—which essentially doubled military spending, provided major reductions in revenues and minor reductions in all kinds of spending, except for one category, which I will get to—we were told that the budget would be balanced in four years.

On the right side of this line, this chart demonstrates that that didn't happen. In fact, the deficits exploded over that period, and there is the deficit which is largely being focused on by President Clinton and by the press and by the American public.

But I think we need to recognize that there are some different ways to look at that deficit. This chart, I think, demonstrates the reality of what has happened to us better than any other I know. It demonstrates that in 1946 public debt at the end of World War II was larger than our annual national total income, our Gross National Product. (See chart below.) It was well above 100 hundred percent of the annual total size of the economy. It declined through the years, through 1973, and then it stabilized at about 23 or 24 percent of our annual national income, but it has been rising since 1980 to the point where it has almost doubled since that time.

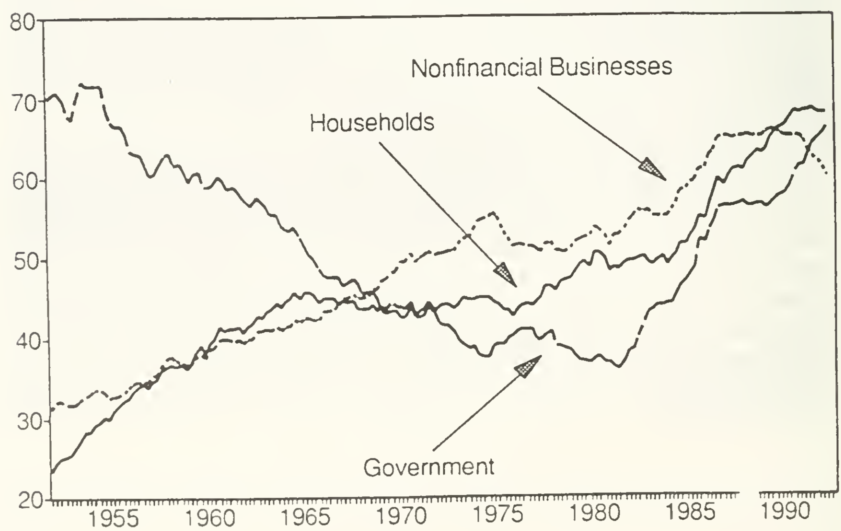
Federal Debt as a Share of GDP



The problem is that it is projected to go off the graph reaching about 70 percent of our annual national income within just a few short years. And it has not just been government which has been wildly in debt, because this chart demonstrates that private debt has risen gradually from 1950 through about 1980 and has again gone off the graph since 1980. (See chart.)

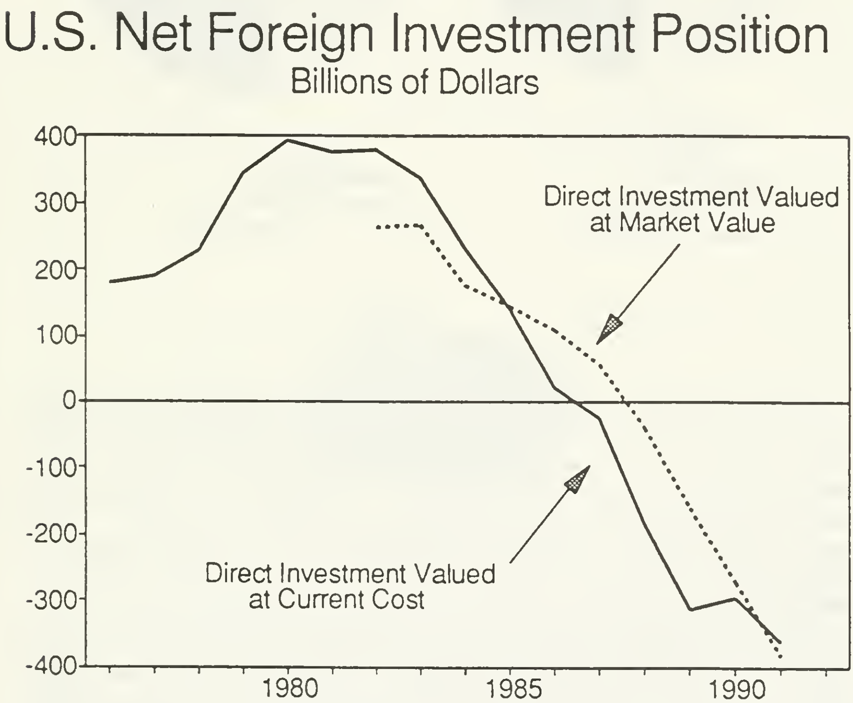
Debt of Private Nonfinancial Sector

Percent of GDP



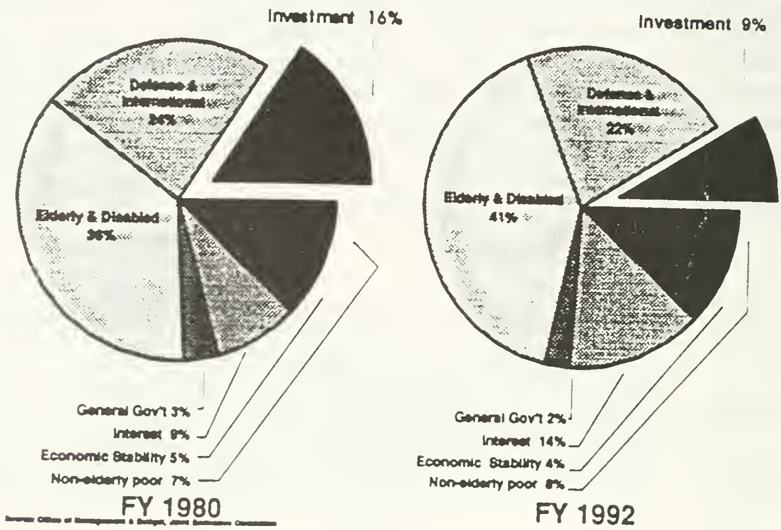
It has absolutely exploded and one of the reasons for our recession today is because the private sector of the economy has been deleveraging a bit, with companies trying to squeeze down their debt and households, at least for a while, trying to do the same thing.

We also have gone into debt to other countries. This green line demonstrates—I should start by saying this is the base line representing neutrality between debts and credits with foreign countries. This green line demonstrates that until about 1987, we actually were running a surplus with other countries. Since that time, we have again gone very deeply into debt. So much for the debt side of the picture. (See chart.)



The second deficit that we face, which is just as serious as the federal deficit, is the investment deficit. I would start by demonstrating what has happened to investment in the public sector in the federal budget. (See chart below.) The federal budget is not usually decided this way by people who analyze it. If you analyze it this way, you would see that this pie represents the way the budget dollar was divided in 1980 and this pie represents the way it was divided at the end of the 1980s. It has changed only marginally since then.

Shrinking Federal Investment



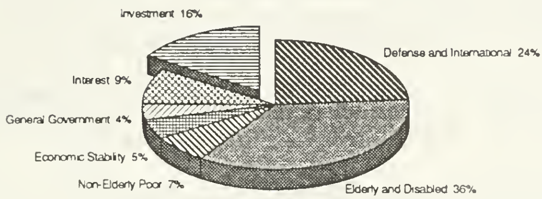
This demonstrates that the largest piece of our federal budget goes to programs that aid the elderly and disabled—36 cents out of every dollar in 1980. It is 38 cents today. It demonstrates that defense has remained about the same. It has gone up slightly since 1980 and then come down again. The nonelderly poor—this little slice here; 7 cents out of every dollar—went to the nonelderly poor in 1980. Roughly 5 or 6 cents goes there today. You can argue about the numbers around the edges.

You have various other pieces of the budget which have moved not much or at all. But if you look at the investment piece of the budget, what we invest in physical infrastructure—highways, sewage treatment plants, the things that are supposed to make other communities more efficient. Take a look at what we invest in science research in order to stay on the cutting edge of technology; what we spend on health research, not health delivery; lots of attention given to AIDS research—for instance since Arthur Ashe just died—items like that are contained in this piece of the budget; and also what we invest in workers and children by way of training and education.

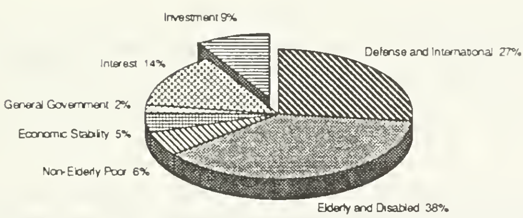
We spent 16 cents out of every dollar in 1980. Today, we are spending in the federal budget nine cents out of every dollar. That is more than a 40 percent decline, and I think that is one of the reasons that we have our economic problem. (See chart.)

Composition of Federal Outlays

FY1980



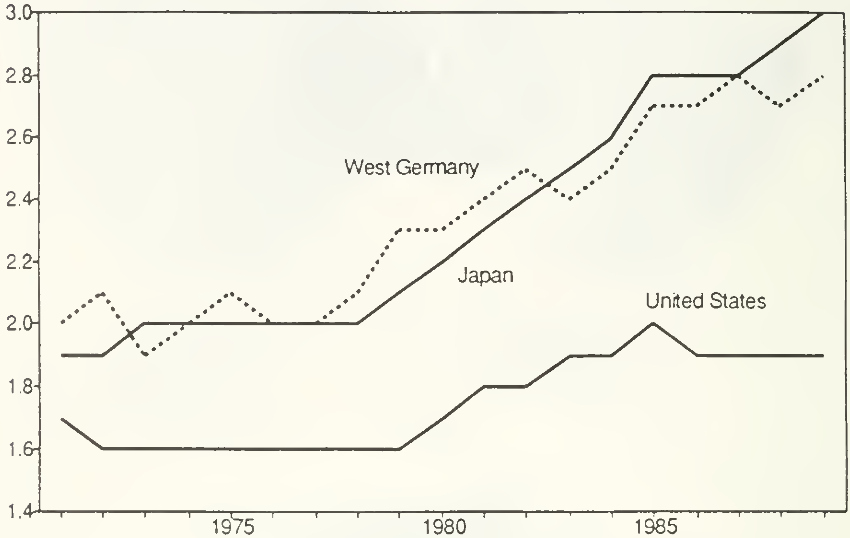
FY1989



This chart demonstrates in the private sector that we have a similar decline in investment. The postwar average of real net investment demonstrates that after depreciation on this side of the green line that the average of that net investment in the private sector was between 6 and 7 percent on an annual basis up until 1980. Since that time, you see that we have only once approached that level, and at this point we are substantially lower in terms of what is being invested in real terms in the private sector, if you take a look at nondefense research and development as a percentage of our total national income.

The West Germans and Japanese started above us in 1970. West Germany has increased their investment efforts from about 2 percent of the total national income to not quite 3 percent. (See chart below.) Japan has gone from less than 2 to almost 3 percent. That is a 50 percent increase. For the United States, you can see we are drifting along substantially below that level again providing a tremendous gap in our long-term knowledge base, and from that knowledge base comes both economic power and prosperity. So much for the investment deficits.

Nondefense Research and Development
Percent of GNP



We have also had a growth deficit. If you compare the performance of the economy in each President's four-year term, that chart is arranged in descending order of growth by four-year presidential terms, and you see that at the end of World War II, President Truman was benefiting from this great surge of prosperity at the end of the war.

We had a huge increase in economic growth during that four-year term; almost 25 percent. Under Kennedy and Johnson, filling in the last year of that term after the assassination, we have the next best record for growth. Johnson had the next best record, although the record was colored by the Vietnam War. Then Reagan's second term, then Nixon's first term, then Carter, then you drift down to Eisenhower's second term, which was the smallest previous record for economic growth, and then you see what happened in the last four years, pretty anemic. That has also produced a decline in job growth.

Again, organizing these charts in descending order of growth, we have the largest growth in jobs in any four-year term under President Carter, over 11 percent, descending down through various administrations, getting down again to Eisenhower, both terms were a little over 3 percent growth in jobs. Under Bush, you had about 1 percent, again record lows.

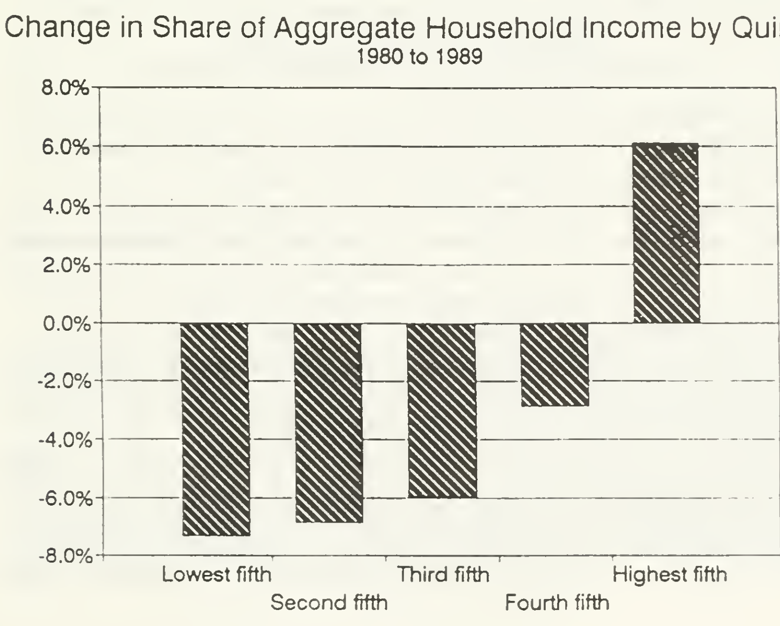
If you take a look at what is happening on job recovery, this recovery versus the average of the seven previous recoveries, you can see that in the seven previous recessions when you were 21 months out from the depth of the recession, you had a pretty substantial increase in jobs; whereas, today we have had just a minor increase in jobs, and this gap represents a lot of pain, a lot of lost economic activity, and a lot of lost income to the government. So much for the growth recession, or the growth deficit, I should say.

All three of these deficits, in my view, have produced a deficit in family income, and these charts demonstrate to some degree what that looks like.

This demonstrates that in terms of real hourly compensation, when you take both wages and fringe benefits, you see that we were rising steadily up until about 1973 or 1975, then we peaked. We have been struggling to break through that ceiling ever since, and we are just not making it.

When you subtract fringes and when you look only at nonmanagement workers in the economy, you can see that since 1980 we have had a decline from about $7.80 per hour to about $7.43 per hour. Again, that is significant. The squeeze has not fallen equally on workers or families.

This chart demonstrates the change in share of total national income obtained by various income groups in our economy over the last decade. (See chart below.) This shows, for instance, that the poorest 20 percent have had the largest decline in their share of income; this black line representing there had been no change at all. You see the poorest fifth have had a substantial decrease in their income.



The next poorest fifth also have a significant decrease. You have to get all the way up to the top of the percent represented by this line in order to show groups that have had an actual real increase in their share of income over that period. It has only been the top 1 percent who have had a large increase in their share of national income. So when we deal with these issues, we are not just dealing with questions of growth, we are dealing with questions of fairness and equity as well.

I think any package which the President sends down and which does not deal with the issue of how you fairly distribute pain, no matter how successful it appears to be in attacking the other growth problems, it simply would not make the grade. And I think that the White House clearly recognizes and understands this, and we will see shortly what they are recommending to the country.

Today, as I said, we were supposed to have three witnesses who can give us some good advice about how to deal with these problems. One of them, Larry Kudlow, is not going to be here because he is stuck on a plane in New York. But we have Dr. Lawrence Chimerine, Senior Economic Counselor of DRI/McGraw-Hill; and Dr. Donald Straszheim, Chief Economist, Merrill Lynch Capital Markets.

Gentlemen, I appreciate your being here. I want to assure you that the fact that no one else is here on the Committee does not indicate a lack of congressional interest. It is just that Congress is out of session, and I am, along with Senator Sarbanes and Congressman Wyden, one of the few silly enough to stay in town. But I think it is worth it.

So why don't you just proceed to make whatever statements you care to make and then we will get to the questions.

Dr. Chimerine, please proceed.

STATEMENT OF LAWRENCE CHIMERINE, SENIOR ECONOMIC COUNSELOR, DRI/McGRAW HILL; AND FELLOW, ECONOMIC STRATEGY INSTITUTE

Dr. Chimerine. Thank you, Mr. Chairman, and welcome back. I am not sure how many years it has been since you headed this committee.

Representative Obey. Since 1986.

Dr. Chimerine. I am delighted to see you back and maybe, as I teased Paul Sarbanes a few times, the economy will do better under your chairmanship than it has done under his.

Representative Obey. If it does, I will take full credit.

Dr. Chimerine. I am sure you will.

I have been fortunate enough to have appeared at this Committee at least three or four times in the last several years, and my views haven't changed a lot. I will try not to be too repetitive.

It seems to me that there are three broad policy questions that need to be addressed. First, do we need a short-term stimulus package, and if so, what should the components be? Second, do we need a program to reverse what you and I agree is a period of long-term stagnation or decline, and if so, what should that program be like? And third, is the

deficit a serious problem? Do we need to reduce it, and if so, how should that be done?

I would like to address all three as briefly as I can this morning, and I would like to start by giving you my assessment of where the economy is right now.

As usual, there is a lot of disagreement and confusion over that. I think part of the reason that there is such a wide difference of opinion on these policy issues is that many people, I don't think, have accurately gauged and assessed the current state of the economy in this country.

First, the economy is not healthy. I have seen a number of people characterize the economy recently as healthy. We've also seen many supporting statements such as:

> We are doing better than the Japanese. All we had was a mild recession.
>
> The fact that the recovery is so slow shouldn't be surprising because we get slow recoveries after mild recessions.

I think all those characterizations are inaccurate or misleading, because we have gone through a process of essential stagnation for almost four years.

You showed it on your chart on GNP growth during the Bush Administration. In fact, if you adjust that for population growth; that is, put it on a per capita basis, we have had virtually no growth for almost four years, which I think is unprecedented since the 1930s in the United States. This has been the longest period of stagnation certainly in the postwar period, as I have said; and perhaps even longer.

What we have gotten since it has ended, or temporarily ended—we don't know for sure yet—are two quarters of very modest growth. In the old days, we would consider 3.5 percent growth as being average or adequate, not spectacular. In fact, they are likely to revise down the fourth quarter number when the revisions come out later this month, and very likely the next quarter or two will even be below that.

So when you have two quarters of decent growth, at best, following 3½ or 4 years of stagnation and with no visible improvement in the job market at this time, I don't see how anyone can characterize the economy as healthy, particularly when you add in the long-term trends you described a few moments ago.

The truth is that this economy has not been generating any improvements in living standards for much of the population for 10 or 15 years. A large segment of the population has regressed during this period. We have lost our competitive advantages in world markets. In industry after industry, our share of world production has been falling. Productivity growth until recently has been essentially stagnant for a long period of time.

We have gone deep into debt. When you take all of this into account, I don't see how anyone can use the word healthy to describe the economy in the United States as of right now.

I feel very strongly that we do need a short-term stimulus package, and before I describe why and what should be included, I would like to describe where we are now in a little bit more detail and how we got here.

I mentioned a moment ago that we have had almost four years of stagnation in this country. In my judgment, the stagnation came about for two general reasons.

First, the expansion of the 1980s, as long as it was and as welcome as it was after those two recessions in the late 1970s and early 1980s, nonetheless was somewhat artificial. It was not a supply-side miracle. It was not a magical transformation of the economy. Essentially, it came about as a result of military and construction booms, partly as a result of tax cuts which fueled consumer spending—of course, we couldn't afford those tax cuts—partly from leveraging the system dramatically upward and partly because of a huge inflow of foreign capital that helped sustain economic activity for many years.

All of those forces of growth which produced that expansion in the 1980s have essentially faded away and in most cases are now being reversed; and the second problem is that while all this took place in the 1980s, we weren't building for the future.

Our rates of saving and investment declined, the quality of education deteriorated, productivity growth remained anemic, public investment declined, and our competitiveness in world markets deteriorated. Once those sources of growth in the 1980s faded out, we have had nothing to take their place because we didn't build for the future, and the net effect has been four years of economic stagnation.

Some of the driving forces that have been particularly apparent are now well-known, but for a long period probably were overlooked.

We are deleveraging the private sector. It not only has exerted drag on the economy in recent years, but it has made monetary policy relatively ineffective and is perhaps the main reason why the consensus forecast has consistently been wrong in recent years, because it has expected more of a response from Fed easing than we have actually gotten.

We are cutting military spending dramatically. We are reversing the construction boom of the 1980s. In many parts of this country, we are now in a construction depression, particularly in commercial construction. And not only are the military cutbacks and the dramatic cuts in construction holding back the economy directly, but they have very high domestic multiplier impacts.

We don't import empty office buildings. We make empty office buildings here, and the same with military spending. Most of the activity takes place here and as a result, the indirect drag is also very substantial.

State and local budget problems have been straining the economy because of tax increases and spending cuts. The disinflation which is characterizing the economy has also been a short-term drag, causing

major cost cutting, particularly in the form of job terminations. And confidence is low because many employees are worried that they will be on the next list of layoffs.

So the combination of weak income growth, because of wage cuts and a poor job market or employment reductions, coupled with a low level of confidence, has at least until recently held back consumer spending and has perpetuated the process of economic stagnation.

I think that is an accurate description of what has happened. You can't grow an economy forever by building empty office buildings and Patriot missiles and by leveraging the economy further. That process ran out of steam, is being reversed, and because the long-term fundamentals are so poor, this economy has performed very poorly for a very extended period.

In the recent four or five months, we have seen some improvement in the economy. We began to see it in the August-September timeframe. It is most notable in retail activity.

The discount stores, the traditional retailers, the niche retailers are all reporting better activity over the past four or five months. It was most obvious around Christmas, but has continued beyond that. January was fairly strong and the first week of February was okay for the retailers, as well.

Housing has also improved somewhat and even some of the manufacturing industries are reporting a better tone to sales and orders. It is still somewhat uneven, but many of them for the first time in several years are reporting better order rates.

The question is why is this happening, and is it likely to persist? In my judgment, it has been retail-led and results from three factors.

One, the decline in long-term interest rates over the last 12 to 15 months has permitted a huge amount of refinancing, both for corporations and for households—particularly for mortgage debt—which has freed up a sizable amount of purchasing power and corporate cash flow, some of which is now flowing into the spending stream. Traditional income growth, particularly wages and salaries, is still very modest, but we are seeing some freeing up of spending power because of refinancing.

Second, these lower, long-term interest rates have had a direct benefit on the economy by helping the housing industry.

Third, I think there is some pent-up demand for certain types of goods, particularly consumer durables and apparel, after a number of very lean years. More and more, people feel they have to replace some of the old things that are wearing out.

And finally, there seems to be a Clinton impact—either Hillary or Bill, I am not sure which—but confidence picked up right around the election. That may have had something to do with the fact that the campaign was over and we didn't have to watch it every night on the news. But whatever it was, at least temporarily, confidence has improved and the combination of a freeing up of some purchasing power

and some pent-up demand, as well as a higher level of confidence has spurred more consumer spending.

Even with all of this, the underlying growth rate in the economy is no better than 3 percent, maybe a tad higher, but not significantly above that, and it is still an open question about whether this can be sustained, because there are a number of factors that suggest that the economy may perhaps soften a little bit, or slow down in terms of growth in the immediate future.

First, we are still not creating a significant number of new jobs, so income growth is minimal at best.

Second, as you heard yesterday, the tax burden will rise in the next several months because of smaller refunds for many families. This is the reverse of the cut in withholding that we had last year.

Third, conditions overseas are extremely weak, particularly in Western Europe and in Japan. The reports that I am getting out of Germany indicate that the German economy is deteriorating very rapidly. People who are talking about it bottoming out in Western Europe, I don't think are aware of what is happening right now. The opposite is occurring. It may bottom out in three months or six months, but it isn't bottoming out right now, and I am getting an increasing number of reports of soft-export orders from some of the major manufacturing exporters in the United States, particularly those who export heavily into Western Europe and Japan.

I think we will see sizable weakness in exports in the next six to twelve months. This is significant, because prior to the last six months, whatever tiny growth we were getting in this country came from export growth. So this will hold us back.

It is also hard to say whether the higher levels of confidence will continue. If for any reason confidence in the new Administration starts to fade a little bit or if continuing layoffs begin to scare people again, it is very possible that the upsurge in confidence will be reversed. In fact, most of the surveys already show a little erosion during the last month. That is not the stuff you hang a strong recovery on.

Many of the ongoing structural factors—deleveraging, the continued negative drag caused by overbuilding, continued defense cuts, and so on—are also still in place to a degree. They may not be as much of a drag in some cases now as they were two or three years ago, but on balance they are holding back the economy.

When you add all this up, the most likely outcome is that at best we will see a slow, gradual recovery. In my view, 2.5 to 3 percent rate of growth is the absolute best we can expect during the next 12 months or longer. And the downward risks are sizable, particularly if, number one, the recessions overseas last longer or are deeper than we now expect; or second, if consumer confidence erodes very sharply over the next few months as it has done on several occasions during the last several years. So we are not out of the woods yet; quite the opposite.

Until we see a stronger job market, I don't see how anyone could be confident in any forecast that growth will accelerate or be maintained at the 3 percent rate that we have had recently.

When you put all this together, in my judgment, a short-term stimulus package therefore is a good idea. It is important for two other reasons as well.

Number one, to help strengthen the economy in the short term and buy insurance against the downward risks so that when we have to phase in the bitter medicine of deficit reduction, we will be starting from a somewhat higher and healthier base.

Second, if we structure the stimulus package in order to try as much as we can to generate an investment-led recovery, we can simultaneously begin to address some of our long-term problems—those long-term problems which you articulated very well earlier are enormous. I think most of them reflect across-the-board underinvestment in the United States. We don't invest enough in private plant and equipment, in infrastructure, in R&D, in education and in job training. In my judgment, our principal long-term goal has to be to increase investment in all these areas. If we structure the short-term stimulus package in a way that does so, I think we gain from that in the long-term as well. If we just have an across-the-board tax cut, I don't think we will be accomplishing much.

Third, I think the program has to be constructed in a way that makes it very cost effective, by getting the maximum bang for the buck, and it can be done without increasing the deficit too much. Otherwise, we start with a much higher base for the deficit, which makes it more difficult to achieve deficit reduction on a long-term basis.

What should the components of that package be? As I have testified here several times previously, I am a strong supporter in the incremental investment tax credit. It has a high bang-for-the-buck. It will work well right now because corporate cash flow is improving, so many corporations do have the cash flow to fund higher investment if the incentive is there at the margin, but without giving them revenues for investments that they would have made anyway.

I am a big supporter of the sliding-scale capital gains tax. I would like to raise the capital gains tax rate on short-term trading and short-term investments, scaling it back to a very low rate on long-term investment, because I think that differential has to be made larger in order to encourage more of the long-term investments that this country needs to improve productivity on a secular basis.

You can do that without losing much revenue, because whatever revenue loss you would get would be made up from the increase in the rate on short-term gains.

I think forward shifting some infrastructure spending, particularly by giving increased grants to cities and states that have viable, useful productivity-oriented projects on the drawing board, should also be part of a short-term stimulus package.

I endorse the idea of looking at regulatory reform and bank capital requirements to see if there is some way to provide more incentive to the banks to make riskier loans particularly to smaller businesses. There has been a credit crunch in recent years, particularly for the small business sector.

It is somewhat exaggerated because the prime reason lending has been so weak is on the demand side because of deleveraging, but it has been difficult for smaller companies to raise capital. I think that ought to be looked at as part of the stimulus package. I also think we ought to look at our trade policy in the short term.

At today's exchange rates, auto parts and components that go into TVs are much cheaper in the United States than in Japan, yet the Japanese continue to import almost all of the parts used in their transplant production in the United States.

I think there ought to be increasing pressure on the Japanese to take advantage of current exchange rates and the significant productivity improvements in some of those industries in the United States and source more here.

I think there are a couple of things that ought to be considered to strengthen consumer spending in the short-term in order to help bolster the investment environment.

The Administration's idea of extending and widening unemployment benefits and restoring some of the cuts in other safety net programs is useful as both a humane measure as well as to provide stimulus in the short term. The marginal propensity to spend out of those programs is very high.

I also advocate a shift in the social security tax, at least the employee portion. I would like to see the wage ceiling raised and the rate cut in a revenue neutral way to shift the social security tax burden, to some extent, to people in the upper-income groups, and reduce it for people with middle and lower incomes. By keeping the revenue the same, this doesn't increase the deficit, but there will be a shift in spending power from the upper-income groups to the lower groups.

It makes it fairer and would help the President to keep a commitment or a promise he made in the campaign of providing a little bit of relief to middle- and lower-income groups without widening the deficit. So these are the components of what I think would be a useful short-term program. It would have a modest impact on the deficit, in the $20 billion to $25 billion range. It is affordable, and I think we will buy some insurance against the downward risks and probably speed the recovery process up somewhat.

Longer term, as I mentioned a moment ago, the priority is the one you have articulated, to reverse the enormous underinvestment that we have had in this country on a long-term basis, and I mean underinvestment in productive assets, private plant and equipment and all of the human and other types of investment that I laid out earlier. Our investment needs are enormous.

I think there are a number of things that the Federal Government can do to lead this process, and I think they will have to lead the process.

First, is on the macro-policy side. It is essential that we cut these deficits. I disagree with some of the witnesses who appeared earlier and understated the deficit problem. It is a serious problem. It is chewing up most of our national savings, particularly at a time when private savings are very depressed.

We are not attracting foreign capital like we did in the 1980s. They have other uses for their capital, and as a result, if we are going to fund more private investment in the years ahead, we must free up public borrowing by reducing our deficits, and we must bring down long-term interest rates to assist in that process.

In one moment, I will describe how I think we ought to bring the deficit down.

Second, I think the Federal Government should articulate quantitative goals for where we want this economy to go in the next 10 years. What should be our goal for GNP growth? What kind of growth in productivity do we need to have in this country in order to achieve that kind of growth in GNP? What kind of saving rates and investment rates and SAT scores and similar kind of measures do we have to strive to in order to generate that kind of productivity growth and that kind of GNP growth?

Third, I think the Federal Government has to dramatically reorient its own priorities.

As you pointed out earlier, Mr. Chairman, government investment has fallen, particularly spending on the young, and spending on productive type of activities. Increasingly, our government moneys are being spent on either consumption or military spending or interest, the kinds of things that are unproductive. We need a huge shift in priorities toward more public investment at the same time we cut budget deficits.

Fourth, R&D, which means providing more incentives for private investment through more tax credits, particularly for R&D, but also for fixed investment, and as I said earlier, also cutting the deficit to free up the savings so that if there are these incentives for private investment, the capital will be available to finance it.

I think it is vital that government take the lead on this. We are going to have to be creative. We are going to have to leverage government R&D money with private R&D money.

There are going to have to be more public-private partnerships to fund infrastructure. We may have to privatize existing government-owned facilities to raise capital to finance new public investment, but obviously a lot more creativity will be needed than we have had in the past. But if government does not take the lead on this, it is not going to get done.

Lastly, as I have mentioned two or three times already, is cutting the deficit. In my judgment, it is vital that we do so for the reasons I have mentioned.

The only word I can use to describe the outlook for the deficit, Mr. Chairman, is frightening. It is absolutely scary how bad that deficit problem will become as we go forward if we do nothing about it. They are already very destructive for the economy, keeping real long-term interest rates excessively high, they are squeezing out productive investment, increasing our dependence on foreign capital, and we must get the deficit down.

I think cutting it in half in five years is a reasonable starting point. In my own judgment, there are some nondefense discretionary programs that we ought to cut, but a lot of that has already been done in the 1980s and there is not much room left, particularly in view of the necessity for increased funding for some of those programs.

There is probably also more room for defense cuts, but there is no way to achieve a reasonable target for deficit reduction without dramatic cutbacks in the entitlements and without some revenue increases.

I don't think this country can afford the notion of entitlements any more. In my judgment, all of these entitlements have to slowly be converted towards mean-testing programs. But over the next five years, it is clear that we need meaningful health-care cost control, and on top of that we need to, in my judgment, fully tax social security benefits and health-care benefits.

We fully tax unemployment benefits. We surely can fully tax pension and health benefits that accrue to the wealthy, people who don't really need those benefits. I also think we should gradually increase the retirement age for full benefits, and as time goes on, introduce a means-test for full benefits.

Everyone in this country should receive benefits, but in the future, it seems to me, that people with high incomes or high wealth should get lower benefits, particularly in the health and pension areas, than those people who need to live on those benefits on an ongoing basis.

Even after all that is done—entitlement reform, more defense cuts, discretionary cuts—the arithmetic is clear. Some revenue increases will also be needed.

The argument that you hear repeatedly is that the problem is not on the revenue side. As a share of GNP, revenue is no higher than it was 10 years ago, is a very misleading argument. We took about a percent-and-a-half worth of GNP out of revenues in the early 1980s. The only reason we are back to where we were then is because of the social security tax increases and other tax increases that we enacted in succeeding years. There was no supply-side effect on revenues. We eroded the tax base in that period.

And second, spending as a share of GNP is higher because of the way the deficit is feeding on itself through the interest component. We will be spending 20 percent of our expenditures on interest in a few years, and that coupled with the upward spiral of health care costs is why spending has been going up, not because we have adopted a whole new set of spending programs.

In my judgment, the best way to get the revenue is to broaden the tax base. Before we raise tax rates, I think for us to scale back many of the tax preferences and tax expenditures that now amount to something like $350 billion or $400 billion a year.

My personal favorites are scaling back or eliminating the interest deductibility for mergers and acquisitions, putting a cap on the interest deductibility of home mortgages—there is no reason for us to subsidize millionaires who buy mansions. Perhaps certain types of unnecessary corporate expenditures can be scaled back in terms of deductibility, and there is a whole range of other base-broadening measures that would eliminate costly tax preferences and raise substantial revenues—scaling back the deductibility of health insurance premiums is another example—before we increase rates dramatically.

Second, if we do have to raise taxes after broadening the base, I think we ought to raise taxes on those things we want less of, like energy and alcohol and tobacco, before we engage in broad increases in tax rates across the board.

So that is the way I would do it, starting with entitlement reform and other expense reductions, when we get to the tax side, broadening the tax base as much as we can by eliminating tax preferences for unproductive activities, and then increasing rates selectively on those things that we would like to discourage consumption of, rather than across-the-board tax increases, although I do favor an increase in the top marginal rate.

I think that, combined with a reduction in the long-term capital gains tax rate, would promote more long-term investment and risk-taking in the economy, which is what we need.

On that note, Mr. Chairman, I will quit and look forward to your questions a little bit later.

Thank you.

[The prepared statement of Dr. Chimerine starts on p. 45 of the Submissions for the Record:]

Representative Obey. We have heard what the package would be if we had President Chimerine. Now let's hear what it would be if we had President Straszheim.

STATEMENT OF DONALD H. STRASZHEIM, CHIEF ECONOMIST, MERRILL LYNCH CAPITAL MARKETS

Dr. Straszheim. Thank you very much Mr. Chairman. I am pleased to be back today. I want to initially say I again appear on my own behalf and my views should not necessarily be interpreted as those of my employer.

Let me first just give you a list of some fundamental points without amplification and then deal with a variety of other points in more detail, and at that time I want to look at some of the exhibits in the written testimony that I have provided, those points being as follows.

I think there is really also disagreement on the goals that we are trying to reach for this economy among the people in this room and really all over the country. I believe the economy is recovering at quite a satisfactory rate, about 3 percent or thereabouts, but after a period, a long period of substandard and quite poor performance.

Any fiscal stimulus should be modest and should work for, not against, our longer run objectives. We need more public investment; I think much more. But it should come via less public consumption. We need more private-sector savings and investment, and there are steps to take and steps to avoid to make sure that happens.

I think the Tax Code needs a complete overhaul, not just a tune-up, and its purpose should be to induce savings and investment to tax consumption more than taxing income, because that is what will accelerate our longer run growth rate.

I think Washington must focus more long-term not short-term, not on the up-and-down wiggles and jiggles in the economy. The President's deficit reduction plan needs to be bold. It needs to be credible and it needs to be long-term focused.

I think the deficit should be closed primarily by bending the spending line down toward the tax line, not by bending the tax line up to the current spending line. No plan will be credible presented to the public that does not dramatically slow the growth-in-entitlements payments that are just over- whelming the budget.

All must share in the sacrifice if there is any chance of this budget repair package being regarded as fair by most.

Lastly, the solution to our budget problems is not mysterious, it is just painful.

Now, with that introduction, let me talk about the economy, talk about fiscal stimulus, talk about savings and investment, public sector investment, the Tax Code, and some of the spending programs.

With regard to the economy, it is not strong, but I think it is stronger than it was. We had about 3.6 percent growth in the second half of 1992. Our own estimate for 1993 is for a growth rate of around 3 percent.

This recession was unusual, in that it was created, it seems to me, by a host of structural problems that were long in developing and, I think, are not really susceptible to a short-run quick fix to any real extent.

Our average growth rate in the recovery in the entire postwar era in the first six quarters of recovery, 6.4 percent. One of your charts indicated something to that extent. This time our growth rate has been about a third of that. That is history. We are now, I think, at a growth rate of around 3 percent, and the question is whether or not we should try to increment our growth rate over the next four quarters to something like that 6 percent rate.

My own view is no. I think that would cause more problems, aggravate more problems than it would cure. I think we should have a longer term focus than that.

It seems to me that the economy in February 1993 looks quite different to a lot of us than it did, say, even in September or October 1992; and, accordingly, I think we ought to be quite cautious and modest about our abilities to look at the economy and precipitate precisely where it is headed and, accordingly, precisely what we should be doing in terms of stimulus.

No stimulus package that is contemplated ought to aggravate the longer run problems. It ought to help solve the longer run problems. It seems to me that the investment tax credit is a worthwhile venture. It would give you some increment to growth quite quickly, it increments our longer run productivity and investment, and I think it is worth doing.

Infrastructure spending—as you well know, we have badly underinvested in infrastructure over many years, and there is a natural fit here, in the short run, in the sense that there is significant underemployment in the construction trades; there is a lot of unused capacity in the construction trades; and there are airports to upgrade and potholes to fill and bridges to repair and so forth—the natural match there that we ought not let skip by. So, in that sense, I think some short-run stimulus would be quite appropriate.

The chart that you used, the fifth chart that talked showed the decline in public sector investment, ought to be fixed, and that decline is costing us in our long-run growth rate.

That also argues for the infrastructure program and, to some extent, education, Head Start, and a variety of these other programs that I will not go into at the moment. I think this all makes a great deal of sense, as well.

Now, on employment, the recession was unusual and companies' response to this recession has been unusual as well, and we have seen company after company layoff overhead in a permanent way. These people are not going to find their jobs back at their prior employer.

White collar employment in the manufacturing sector is down sharply. A great many people are now working part-time because they cannot find full-time jobs, and so forth.

We are not likely to fix this very quickly with some kind of new program. Companies hire people because they think they are going to be able to generate more revenue through their business activity than it costs them to put this person on the payroll. And while we all want to see jobs created quickly, I don't think there is a government mechanism which will induce that employment increase quickly in the private sector.

And I would also add that in this concern about our economic growth in the next few quarters or months, raising taxes is not likely to encourage people a great deal. And if there is, in fact, some risk to consumer confidence and the economy weakening again, tax hikes are likely to be a problem there, not a cure.

There are a variety of other issues along this same cost front that I want to mention quickly. Increasing regulation has some benefits in a variety of different ways in our economy. But in many cases, these are also cost items that companies find that they have to pay, and we need to be very careful at measuring the benefit of that regulation, whatever it might achieve, versus the cost that it imposes on the company that then finds that they cannot, in fact, hire as many people as they would like.

I note the discussion about increasing the minimum wage. I think this is a pure minus in terms of job creation in the foreseeable future.

Now, let me go on and talk a bit about the deficit, on both the tax and spending side, if I could. And to do that I would like to turn to Exhibit 6 in my testimony, an exhibit titled "Budget Estimates of the Presidents."

This curious looking chart shows the federal budget deficit from 1975 up through fiscal 1992, and what we see as the deficit has risen from roughly $60 billion in 1975 to $290 billion in the most recent fiscal year completed. The little lines that angle up and to the right with a date behind them are the official estimates of the budget by our presidents as of those relevant dates.

Two items that I would point out here. First of all, our presidents have suggested that there is great progress on the horizon, but it never materializes. No wonder the public is cynical about the budget process and our decisions.

Second, if you look at the 1992 and the 1993 estimates, they show, I think, a disturbing new development in two ways. The first is that they never ever approach balance even remotely. Second, in the so-called outyears, they show the budget again beginning to deteriorate. I think that is basically the entitlements, payment programs and payments to individuals overwhelming the rest of the budget.

Now, it is true that the economic assumptions that underlie the budget are much more accurate now than they were a decade or so ago, and that is an important plus. But the real difference here is in the entitlements, payments and that part of the budget, and that is what I would like to turn to next.

If you look at Exhibit 7 in my statement, I have a chart here called "Off The Track." It shows the federal budget receipts and outlays as a percentage GDP from 1959 through the present, and then with the CBO estimates from their most recent document, out through the year 2003.

When I look at that chart, I conclude two things: First of all, receipts as a percent of GDP have stayed roughly constant. I mean, they go up and down. The economy affects the budget as well as the budget affects the economy, but, basically, they have been flat.

What is striking is outlays continue to rise. And you note, of course, with the CBO estimates out to 2003, we have a deficit that is 6 or 7 percent of GDP and $600 or $700 billion year after year.

I think this is unsustainable. And, to me, an important question, is how to close this imbalance. We could either bend the tax line up to the spending line or, conversely, bend the spending line down towards the tax line. I believe that the economy will do better out there in 2003 if we do more of bending the outlay line down toward the spending line rather than the other way around.

In the most recent debate, this benchmark has been discussed having $2.75 of spending cuts for every $1 of tax hikes. I think that is the Nunn-Domenici number. I have heard two to one from OMB Director Panetta. Something along that order of magnitude is, I think, what would be desired. I don't think it would be appropriate to have this come out at one-to-one, or something like that.

Now, if you turn to Exhibit 9 in the statement, I want to talk about the outlay side of the budget and, in particular, payments to individuals. This chart shows the bottom line of it, shows that as a percent of total outlays, payments to individuals are now more than half of the budget—54 percent. They have roughly doubled in the last 30 years.

Let me just highlight a couple of these numbers. Social security, the top line, has gone from $30 billion to $300 billion in the last decade. An almost 5 percent real compound growth rate for 23 years. This is so large because this recipient population is growing faster than the overall population. This cannot be sustained. And the question really is when we get around to starting to arrest it.

The proposition of freezing the COLAs for one year has been discussed and seemingly discarded. There is, of course, discussion about raising the taxation of social security benefits from 50 to 85 percent, or whatever. I would have no difficulty with something like that. But I think there is something else which needs to be done, and that is, it seems to me, we ought to change the escalator clause protection in this, and in most other of these entitlement payments, from 100 percent protection to perhaps 90 or 80 percent.

If we changed it to 90 percent instead of 100 percent, and the consumer price index goes up by 3 percent, the recipient doesn't receive 3 percent, they receive 2.7 percent. That costs a few dollars every month, even to the poorest social security recipient.

That is sad, but I think it is important on the spending side of the budget and in the spirit of shared sacrifice, all need to sacrifice. If all don't sacrifice, I think what happens is that it is very difficult to sustain the debate about fairness. And if you do it here, you can, of course, do it across all of these other entitlement payment programs as well.

Health care, zero to $260 billion in the last 30 years. There has been a great deal of discussion about it. This is an ongoing disaster which is well-known, and I don't want to belabor that point.

I would just make one other comment about this chart. Food and nutrition assistance, $37 billion now, up from $1 billion in 1970. There are 24 or 25 million people on food stamps. One out of every eleven

Americans. This is a sad commentary on our economic performance for years and years.

But there is another dimension in this program and in many others. I don't know exactly what the number is, but I think it approaches 25 percent of all of the households in the country receive a check from Uncle Sam of one sort or another every month, and it seems to me that we simply cannot, as a society, indemnify every American against all things bad that might happen to them forever. And that is what this whole explosion in entitlement payments is approaching.

Now, let me say something about the tax side as well, and then I will be happy to take your questions. On the tax side of the budget, it seems to me that what we need to do is induce savings and investment in a variety of ways.

I have already mentioned the investment tax credit, expanding the individual retirement account rules to encourage people to save makes sense. Making permanent the research and development tax credit, the capital gains tax cut that has been discussed and so forth. I would support all of that.

More broadly, I think what we need to do is twist the Tax Code in a great big way to encourage savings and investment relative to consumption, and my own sense is that the value-added tax ought to be given very serious consideration—national sales tax, if you will. Most every other industrialized nation in the world has a value-added tax. Its key feature, of course, is that it is a direct inducement to savings and investment relative to consumption. If you have two people making $50,000 a year, and one spends all $50,000, they pay a value-added tax on all $50,000 of their income. The neighbor across the street spends $25,000 and saves $25,000, they pay tax on only the $25,000 that they spend.

The criticism often voiced against the value-added tax is that it is regressive. It is regressive, but if you do not like the regressivity, and most people don't, it is easy to offset by adding one more line to your 1040 form and make it 300 percent refundable to the poor people, not at all to the rich, and just make it as steep or as shallow as you would like.

Just as the discussion on the income tax right now, raising taxes on the rich is essentially a political matter, a philosophical matter, not an economic matter. You could offset this regressivity with the value-added tax. I think it ought to be a substitute not an add-on. And my guess is that the public would be very skeptical of a new value-added tax, because they would say, well, this is just another tax to raise more and more revenue and so forth.

You could easily enough arrest that by tying the escalation of the value-added tax directly to an offsetting cut in the income tax over some longer period of time. The consumer income tax proposal, which Senators Nunn and Domenici have talked about, would be another one.

The last thing I want to say about taxes is, to the extent that we try to resolve the budget deficit by raising taxes, I think we are going to find ourselves frustrated, at least to some extent. Companies will take these tax increases that they pay and either pass them forward in terms of higher prices for the products they sell to their customers or pass them backwards in terms of lower wages.

These taxes, whether we are talking energy taxes or an increase in the corporate income tax or whatever, is a cost to most companies, and most companies don't regard it as much—nothing really more and nothing less.

Lastly, two other just quick comments. There has been a good bit of what I would describe as Fed bashing in recent weeks and months. I think the country has been well-served by an independent Federal Reserve, and it seems to me that none of us know the future and we are doing a lot of Monday morning quarterbacking and second-guessing with regard to the Fed. I think their goals for the economy are roughly consistent with the goals of this Committee and the new Administration and so forth. The question is in terms of the means.

My own view is perhaps the Fed could have been a bit more aggressive in lowering rates, but that is, I think, with the benefit of hindsight, not more. And the higher profile this criticism of the Fed is in the current environment, I think the more trouble it potentially creates, because I think the Fed would find themselves very hard-pressed to absorb a lot of public criticism about their policies and then turn around and ease policy. I think it works precisely backwards.

Lastly, reforming the budget process. I think our budget process is imperfect and could be fixed and improved in many ways, but I think there will be a great attraction to substitute debate about reforming the budget process for what we really need to do, which is, make the hard choices.

Let me stop there, Mr. Chairman. I appreciate the chance to come in today and will be happy to answer questions.

[The prepared statement of Dr. Straszheim, together with Exhibits 1-13, starts on p. 59 of the Submissions for the Record:]

Representative Obey. Thank you both very much. Let me start where you finished. I am impressed by the fact that both of you agree pretty much on the last statement that you made when you say that we should not substitute process reform for political will in attacking the deficit. I don't know who your philosopher is, but mine is Archie, The Cockroach. He was a character invented by a writer by the name of Don Marcus back in the 1920s, and he was supposedly a poet who had died and come back to life in the body of a cockroach and he lived in a newspaperman's office. He would crawl out of the woodwork every night and dive head first onto the keys and type these little messages which would appear in the newspaper the next day.

I have an old version, very old, as you can see, of his book. This is my political bible, because it has an observation for virtually every

occasion, and if I can find it, he says something which really agrees with what both of you said. He said:

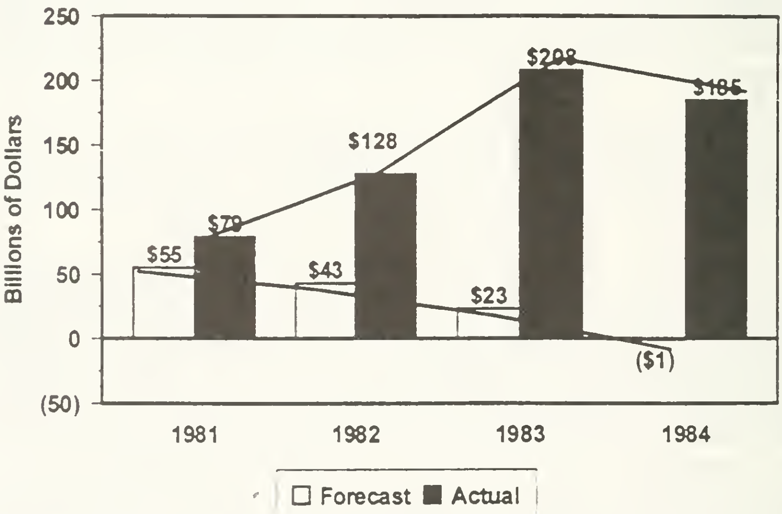
> Man always fails because he is not honest enough to succeed. There are not enough men continuously on the square with themselves and with other men. The system doesn't matter so much, the thing that matters is what men do with any system they happen to have.

And I think that could just as easily apply to the budget system.

And because I am a chart junky—Ross Perot isn't the only one—I have some other charts that demonstrate the wisdom of what both of you said. I don't mean these to be partisan, because as you indicated, all presidents—certainly as long as I have been here—have had wildly optimistic budget assumptions, and we have never met, really, any of them very closely.

But this chart demonstrates that in 1980, when we were told that if we adopted the magic fix—and then it was not a procedural fix, it was a substantive fix—we were told that if we adopted that four-year proposal, the deficit line would go like this—represented by the green bars, and this black line down to zero within four years. But these red bars and this black line indicated whatever happened. So that is the line that measures promise; that is the line that measures actual performance. Quite a gap. (See chart.)

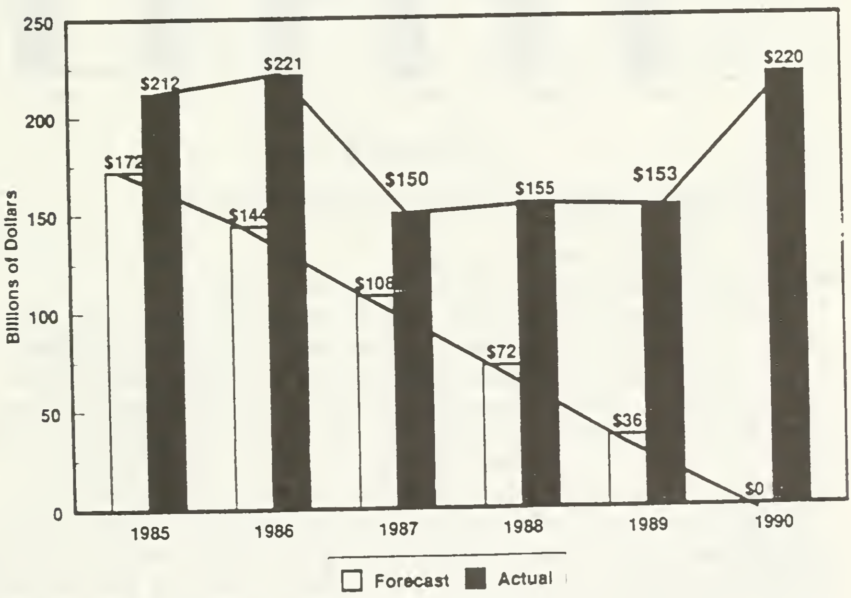
Reagan Administration Promises vs. Performance on Deficits, Fiscal Years 1981-1984



Source: Office of Management & Budget, Joint Economic Committee

When the politicians in this town saw that this was happening, what did they do? They proposed something called Gramm-Rudman or Gramm-Rudman-Hollings—Fritz then decided he wanted to disassociate himself from the endeavor—that set up a mechanical process by which we guaranteed—and I shouldn't say we, because I voted against it and said it was a public lie. Not that they were trying to lie, but I thought the results would be that—the green bars demonstrate what was supposedly going to happen to that deficit under those nice, even mathematical promises that were made to people. They were going to drop in $36 billion increments every year until they were down to zero by 1990. And we had locked ourselves into the Gramm-Rudman straitjacket in order to make sure that that would happen. (See chart.)

Reagan Promises vs. Performance Under Gramm-Rudman I
Budget Deficits, Fiscal Years 1985-1990

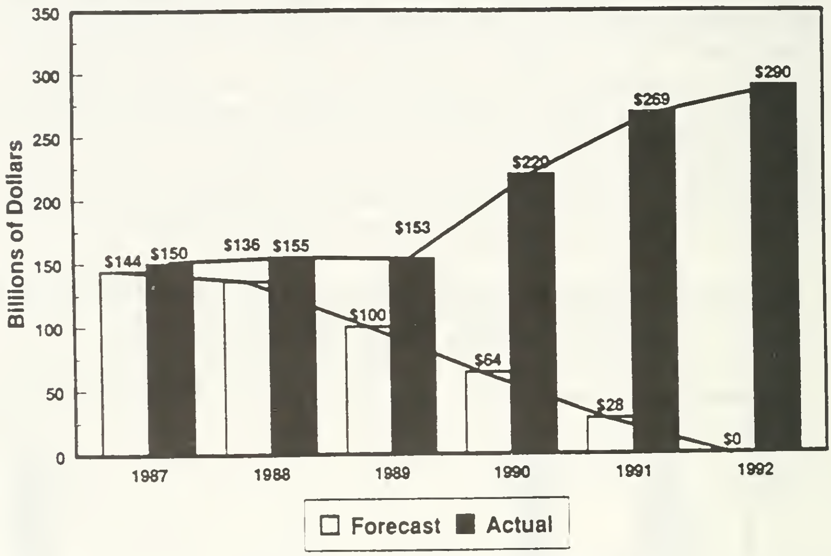


Source: Office of Management & Budget, Joint Economic Committee

Well, again, the red bars demonstrate what actually happened. Even with a procedural straitjacket, instead of zero in 1990, we have $220 billion. That is missing the target by a little more than most hunters do in my district.

This, then, shows what we did when the Congress tried to fix it up with magic fix number two. Gramm-Rudman II, again, promised that through this nice clear mathematical formula, we would get to a deficit of $144 billion in 1987 to zero in 1992. (See chart below.)

Reagan-Bush Promises vs. Performance Under Gramm-Rudman II
Budget Deficits, Fiscal Years 1987-1992



Source: Office of Management & Budget, Joint Economic Committee

Again, what happened is that for three years it remained level, and then it ballooned up again to the $290 billion in 1992.

God knows where it is going to go next year. I think those three charts demonstrate that whether you are under Republican or Democratic Presidents, and whether the Congress is Republican or Democratic, if we focus all of our energy on designing the straitjacket, if we focus all of our energy deciding what the process is going to be by which the surgeon attacks the problem rather than simply getting people in the operating room and saying do it, we are pretty foolish.

I think that is really what the average citizen means when he says to a politician, "For God's sake, boys and girls, be real." They want us to do the real things, not promise fancy things through a process that never gets delivered. I think that is the number one message that we ought to take from all of this.

I have a number of other little mini speeches I want to give in response.

Dr. Chimerine. May I comment on that.

Representative Obey. Yes.

Dr. Chimerine. I think that when the history books for the 1980s are written, they will say the following: First, I think we have done a lot of long-term damage to the economy; secondly, the burden we are placing on future generations is absolutely irresponsible. I mean, it is unconscionable what we have done in that respect, but with respect to the

budgeting process directly, it was clear from day one that when we implemented what is now being called "Reaganomics" in the early 1980s, we were building in huge budget deficits forever.

We didn't address them afterward. We used a combination of fraudulent budgeting, or near fraudulent budgeting, with optimistic assumptions and gimmicks and whatever, including some of the things you have talked about, and then a combination of budgetary rationalizations and budgetary myths which allowed us to feel okay about it—they are not going to hurt the economy, or we will grow our way out of it—which ultimately led to complete indifference and neglect.

And what was a problem that could have been addressed with a modest amount of spending cuts and tax increases five years ago, at a time when the economy was growing, became a bigger and bigger problem because it fed on itself.

Essentially, we did a leveraged buyout of the Federal Government. Interest is now dominating the whole budgetary process and spending growth. It is chewing up whatever you cut everywhere else.

Representative Obey. I remember when Senator Domenici and Speaker Foley tried to interrupt that in the 1980s, and they got cut off at the pass at the White House when they tried to sell it.

Dr. Chimerine. It goes to what you said about leadership. We need leadership. And we haven't had it for the last 12 years, in my view. We need concrete policy changes, not a balanced budget amendment, not line-item vetoes, not all the other gimmicks that don't tell us how we are to do it.

I favor very strongly enacting a multiyear deficit reduction program now. I agree with—what was his name, Archibald?

Representative Obey. Archie, the cockroach.

Dr. Chimerine. Archie, yes. It is less important how we do it precisely than the fact that we do it, particularly since we all tend to overstate the incentive effects of tax changes. I do agree that we want to do it the best way we can, but it is important we do it.

I want to make one other comment about that. Not only should that be put in place, but there are some people, quite frankly, some economists on the left, who say, well, we cannot do that because it will slow the economy too much, or the Fed must be pressed to offset the fiscal drag.

I don't think we can be confident that the Fed can offset the fiscal drag, given how low interest rates already are in the short end; and, second, how relatively ineffective federal policy is in this environment where we don't control our long-term interest rates any more.

Furthermore, the economy is still overloaded with debts. I favor putting in some kind of an escape clause, because I don't want to depress the economy too much, and none of us know for sure what the best time pattern of deficit reduction is.

I would put a program in that would cut it in half from current projected levels, but for any year, let's say 1995 or 1996 or 1997, if under-

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lying economy growth falls below a threshold level, then that year's installment of deficit reduction would be scaled back or delayed until the economy is growing at an acceptable rate so that we don't push us back into stagnation or recession for the sake of cutting the deficit.

But I couldn't agree with you more. I think I see an effort to enact the balanced budget amendment resurfacing. In my judgment, it would be counterproductive. It delays real action. It lets the Members go back and tell their constituents, well, I voted for a balanced budget amendment. Unless somebody takes the lead on concrete policy changes, and unless that is what is passed, the financial markets will not be happy; and second, you will accomplish nothing. If anything, you might delay real action.

So I think you are right on, and I hope the Administration will combine the short-term stimulus package with an effective multiyear deficit reduction program starting in a year or two and, hopefully, the economy will be stronger, but with some measures included that can deal with the timing issue. Because we don't want to do it so fast that we hurt the economy. And this was the flaw in the Perot proposal. Going down to zero in four or five years would be too much fiscal drag for the economy to handle.

Dr. Straszheim. Mr. Chairman, could I add quickly on this issue of process?

Representative Obey. Yes.

Dr. Straszheim. Gramm-Rudman was, it seems to me, an effort by the Congress to tie its own hands together in a way in which it cannot untie them, and that is not a logical possibility for any legislative body. It is not the first time.

There is an interesting table in the annual budget document that shows the increases in the debt ceiling—and I think we have increased the debt ceiling something like 80 or 90 times since 1940. We go through these episodes periodically of sending out the social security checks on Monday instead of Saturday, and shutting down the government on Friday afternoon for a couple of hours and this nonsense. The balanced budget amendment, I think, is another procedural gimmick that is of no value. The line-item veto is a procedural matter of modest value.

I think the public has the government's number on this issue, and I think our political leaders continue to ignore the public's outrage at their political peril. In the 1992 election, we had some independent candidates come out of nowhere who got more than half as many votes as a sitting president. You have "United We Stand" out there, and you have the "Concord Coalition" out there; you have the "Strengthening of America Coalition" and "Lead or Leave," and there is probably a variety of others that I have not mentioned. All of that, it seems to me, is asking for not process but simply hard decisions.

Representative Obey. I think you are absolutely right.

Let me ask you a question. I think you said, Larry, it was primarily people on the left who were saying that if you were not careful, you could tip the country into another recession. It is not just people on the left.

I watched after President Clinton had his Detroit Town Meeting two nights ago. I watched Newt Gingrich, the Republican Whip in the House, on C-SPAN, respond to what the President said, and I think I am stating it fairly. I think what Newt's concern was, or at least what he expressed, that he thought there was going to be a recession sometime in the next two years, because he thought any revenue increases that occurred would lead to economic slowdown, and, therefore, tip the country into a recession.

Now, forgetting for a moment whether it is revenue increases or any other combination of events which reduce the deficit by a similar manner, because I think that while we would prefer to have most of the deficit reduction take place on the spending side, nonetheless, you do have, in most instances, a contractionary action, whether it comes on the tax or spending side. But let me ask you, if you take that ideological spin out of the question—let me play the devil's advocate—how do we know that if we, for instance, cut the deficit by, say, one-half over the next five years, as you suggested, that because of the export weaknesses which you cite, because of the rest of the world sliding down, especially Germany——

Dr. Chimerine. Correct.

Representative Obey. ——if they are in a recession, they will not buy our goods and that means fewer job opportunities, because we are not going to make as much so we can sell abroad. How do we know that if you couple that with the fact that we don't have that withholding, or because of the President's withholding gimmick last time around, there is $20 billion less in people's pockets this time around from income tax refunds; if you add that to the fact that, as Newt points out, you have 300,000 job layoffs announced for the coming year—and that is bound to have a depressing effect on certainly the pocketbooks of people who are going to be laid off—how do we know that that combination of problems, coupled with the contractionary effort we would have from deficit reduction—how do we know, with the economy only growing at this point at a modest level, given historical experience on recoveries from economic recession, you would not, in fact, see the country tipped into recession, even assuming that none of the revenue increases would take place until the following fiscal year?

Dr. Chimerine. We don't for sure, but there are two safeguards we can build in to minimize that risk—really, three. One is to provide some short-term stimulus to hopefully ensure the recovery continues, and maybe even strengthen it somewhat so that we are at a somewhat better level when the fiscal restraint begins. Second, even though we should enact it now, I don't think the tax increases and spending cuts—the deficit reduction measures— should start taking effect for at least 18 months or so, maybe not even until calendar year 1995. So, if we hold

it off for a year or two, hopefully some of these factors that will hold back the economy in the short-term will have faded out. And, third, the safeguard I just mentioned a moment ago, I think is a perfectly reasonable way to build in some protection against deficit reduction depressing the economy too much in the short-term. As long as we build that in mathematically in the deficit reduction program, I think we are building in a satisfactory safeguard.

The point is that we should not use the argument that there may be a recession in two or three years to avoid deficit reduction, and I think a lot of the people who are using that argument are doing it because they don't want to cut the deficit, either because they don't think it is important enough or they don't want tax increases.

So I think a combination of these three things, short-term stimulus, delaying the start of deficit reduction for a year or two, even though we enact it now, and building in a threshold effect on an ongoing basis, can reduce that risk, and that is the best you can do. But that cannot be an excuse not to deal with the deficit. If we wait for the ideal time to first craft a deficit reduction program and then start implementing it, we will be waiting for five years or more.

Representative Obey. I don't think there is any doubt that there is going to be a substantial deficit reduction package passed. My question is how do we know that after that is passed that you won't have the same thing happen to us that happened to us in 1980 when we had what, at the time, was considered a major deficit reduction, $16 billion? We were trying to keep the deficit down to around $40 billion, and when you are cutting $16 billion, that is a big percentage of $40 billion, and yet the economy fell and the deficit wound up doubling.

Dr. Chimerine. Again, I think there are two things. Number one is to stretch it out. I am talking about cutting it in half over five years, which is essentially about $30 billion of fiscal drag per year. Not a huge amount. I think it is much too risky to go beyond that for the reason you mentioned. But, second, to have that safeguard built in, that if the economy weakens during this period, we slow that process down somewhat. But, again, the alternative is to do nothing, and I don't think that is acceptable. If you have a better idea as to how we can minimize that risk, I think that would be great, but that is the best that I can think of.

Representative Obey. Let me ask both of you this question. I don't want to have a repeat of what happened in 1981 when the country was promised that if you do something, we are going to get to specific dollar reductions over a specific four-year period—just vote for this baby, and it will happen and we promise, and then it doesn't happen.

I mean, we have to remember that in 1981 David Stockman, who was running the Office of Management and Budget, was already writing notes to himself, that trying to talk budget realities to the people in the White House was like talking to Daffy Duck, and that, as a result, he knew those numbers were already off course, and we were headed for a train wreck.

I don't want President Clinton to have to experience that same problem. I tend to think there is a political trap as well as a substantive trap inherent in what we are talking about. Not inherent in deficit reduction, because I stipulate I think we have to have major deficit reduction, but I think we discredit the political system, we discredit economists, we discredit presidents, and we discredit administrations when we aim at specific dollar numbers, knowing damned well that the economy is such a big gorilla, and it is always going to move or slide one way or another.

So what is important to me is not that we get a program that shows these nice, neat reductions, as it did here, or as it did here, but that we have a credible plan which, over time, will turn this line around. This line is the measurement of debt as a percentage of national income.

It seems to me that things were functioning pretty well in this country from 1945 to 1973 while this line was going down, and it didn't matter a whole lot in any given year whether the deficit was $30, $23 or $41 billion. What mattered is that over time you knew that you were going to be bringing it down.

And, to me, if you want to be credible, my advice to the President would be to not be so wedded to a specific dollar number in any given year, because I don't think the public gives two hoots whether you hit $145 billion deficit reduction in the fourth year, or $155 or $135 billion. And I don't think the public gives two hoots whether it is going to occur in four years or five years or six years, so long as they believe that you are determined to bring it down over time and keep it going down over time, absent a catastrophe, such as we had in World War II when you had to spend whatever was necessary.

So I guess I get nervous, because when you get an awful lot of smart people in a room, they often make a lot of mistakes because they are so smart and see all of these constructs, which may make sense in that environment, but when translated into the real world, when the lack of neatness in this puzzle factory starts to bear on all of us, then we wind up with some very embarrassing results.

I think this is the line we need to keep in mind, and we need to show that we have a serious enough sense of purpose to get there. Do you understand the point I am making?

Dr. Chimerine. Absolutely.

Representative Obey. And do you disagree or agree with it?

Dr. Straszheim. In general terms, I don't think the public does care what that number is. But there will be a number out there for the deficit in 1996 and 1997 and 1998 or whatever, and the media will use that precise number and if the outcome is higher or lower, that will be the measure. But a good communicator will, I think, be able to convince the public that they are on the right track, or if they are not, will have difficulty with it.

But there is one other problem here, I think, on the longer run deficit plans, which gets back to David Stockman's asterisks in the early

1980s. It is going to be some months before we have any idea what the health-care plan is going to be like, and that makes all of these numbers really quite soft. No matter what you do on anything else, that is the one that has grown most rapidly, from zero to $260 billion, and it is just going to be an ongoing item.

The public wants a credible plan, and there is a better chance that we could have a credible plan, I think, with economic assumptions in the budget that are more realistic.

A decade ago, the assumptions were year-after-year blue sky forever, and it just, of course, never materialized. That is at least one safeguard against these numbers being implausibly optimistic. But longer run, it is going to require hard choices and simple diligence and commitment to whatever it is that the plan and the target turns out to be.

Dr. Chimerine. David, can I add one quick comment, too?

Representative Obey. First, one of the reasons I think getting to an annual deficit that is roughly cut in half is important, for the reason you mentioned, it will stabilize that ratio and start bringing it, at least, slightly lower. Whether it is five, seven or eight, I agree that it doesn't matter that much.

And, second, to the extent possible—and it is not possible to do it completely, because, as Don points out, we do focus on the annual deficit—I think the program ought to be oriented not to hit a specific deficit number in a specific year, but to focus on the amount of legitimate real deficit reduction.

So we should put a program in place where the spending cuts and the tax increases and these interest savings that would result will add up, on an annual basis, to, let's say 150 in the fifth or sixth year, which would be equivalent to a 50 percent reduction from the baseline deficit. If it turns out to be only 30 percent because the economy wasn't strong, or because our assumptions were not good, or if it is bigger than 50 percent because of the underlying deficit situation, that is fine. But the point is, it has to be a concrete amount of specific deficit reduction. Otherwise, I don't think anybody will be fooled any more. And if that is not the case, we will never come close to achieving our numbers.

Representative Obey. Let me make one other observation. I think one of the great dilemmas you have is that we had such huge additions to the deficit in the 1980s, that right now we are prevented from doing what we really ought to be doing if we didn't have that huge debt overhang.

Right now, as I understand the numbers, we have a $307 billion deficit, not counting the social security separation. Interest is $199 billion. So that means that right now we are not spending on interest, we are paying the interest. So, in terms of program delivery, which is the way I think of spending, we are spending $108 billion more than we are taking in. If you then subtract that from that figure, the $80 or $81 billion, which is the estimate of what the recession is costing us on the deficit this year, so, if we are at full employment the deficit would

be $81 billion less, it means that the government is spending $27 billion more in program spending than we would be taking in if the economy were at full employment. And yet, we have that huge $199 billion payment which is eating into our ability to do what we need to do in education and in infrastructure, and in everything else.

I think it is important for people to understand that it is not necessarily today's spending that we are having to correct, it is yesterday's spending and the day before yesterday's. It is not that government is spending so much today to attack the problems, such as the investment problems that we have been talking about, it is that we spent so much yesterday for unproductive things that we are now having to pay the piper. I think conceptually it is important to understand that.

Dr. Chimerine. Can I comment on that quickly?

Representative Obey. Yes.

Dr. Chimerine. I think there are three points related to that that are relevant. First, I don't think the public understands how sizable the cuts in nondefense discretionary programs were in the 1980s. The problem is that it has gotten chewed up for a while by defense and, of course, interest and health care costs and so forth. Second, I don't think many people realize that a lot of that $199 billion—I have forgotten the exact number—but $30, or $40 or $50 billion is leaving the economy. It is sucking income right out of the system. And, third, the rest is resulting in a significant shift in the distribution of income in this country. It is going to upper-income groups, and it is worsening the income and equality issue you mentioned before.

So this whole issue of interest and the deficit has a number of effects, all of which, I think, tend to restrain the economy, including limiting more useful, more productive spending.

Dr. Straszheim. Mr. Chairman, net interest has gone from 9 percent of the federal budget in 1980 to 14 percent in 1993, at the same time that the yield on the 30-year Treasury long bond has gone from 14 to 7 percent, and the 13-week Treasury bill rate has gone from 14 to 3 percent. So, at some point in the future, if these rates head back in the other direction, we will have a more seriously aggravated problem.

Second, your chart that showed debts held by the public.

Representative Obey. This one?

Dr. Straszheim. Yes, that is the chart. I think the interesting thing about that one is that its peak was over 100 percent of our GDP in 1945, 1946, but that was because we financed an event with borrowing, and the event was the Second World War. And then, after that event was over, we got these numbers back down.

In the last 15 years, we have not financed an event. What we have financed is this proliferation of these entitlement payment programs, indexed, of course, every one. In our wisdom, we never looked at the fact that the recipient population was going to grow with the demographics, and lo and behold, we are running these numbers up now at this enormous rate, and it is not to meet yesterday's problem, it is to-

day's and tomorrow's problem. Because until we make very fundamental corrections, those numbers will continue to escalate year after year.

The other point I would make, as another reason why we need to get this deficit down, we need to have a fiscal lever to be available in order to pull countercyclically when we have a cyclical problem. I think one of the reasons this recovery has been as weak as it has been is that at the trough of this recession, we did not have a fiscal lever to pull. We pulled that lever a decade ago and we left it pulled. So we need to be sure as a nation, at some point in the future when we fall into recession again, we have the fiscal discretion to pull that lever and pull it hard when we need to. If we don't get the deficits down, that won't be a possibility.

The last quick point I would make is that we need to keep in mind that all spending is not equal, as you have pointed out. And I would argue, even if we don't change the deficit size at all, if we were to alter the composition of spending by the public sector a great deal in the future, more of it being on public investment, less on public consumption, the Nation would be better off because our growth rate would be raised.

Representative Obey. I certainly agree with that.

Let me ask you, Larry, the investment tax credit, you make quite clear that you think that ought to be incremental, and that it ought to be focused on, your term, productivity enhancing equipment. Lay out for us why you think it ought to be temporary and how you define what productivity enhancing equipment would be?

Dr. Chimerine. There are, I think, three issues you are raising in that question. Number one, should it be incremental or not; number two, should it be temporary or not, whether it is incremental; and third, what does it get applied to.

I don't know exactly how we are going to define productivity enhancing equipment. Put it this way, I know we don't need more empty office buildings, so I want to focus it primarily on equipment; and we are probably going to have to make it broadly defined. We cannot go through every single kind of business equipment and decide whether it is productivity oriented or not. So probably a fairly broad definition would be appropriate, especially if we do it on an incremental basis. The beauty of the incrementally designed investment tax credit is that if it doesn't stimulate more investment, it doesn't cost you much. If it does, by definition, you get some more economic activity out of it, which generates some revenues so that you pay a large part of it through the added economic impact. I use that phrase very carefully following the failed supply-side incentive impacts in the 1980s, but this would apply here.

So a broad definition doesn't lose a lot. I think the key question is whether to make it temporary, and my own view is probably a large initial incremental investment tax credit, then perhaps scaling it back so

you get some bunching in the short-term when you need the added economic activity, might be the best way to go.

But, to me, a broad definition is adequate as long as we make it incremental so that we don't give away $30 or $40 billion of tax revenues for investments that probably would have occurred anyway, which is what it would cost us to have a broad-based 10 percent nonincremental tax credit, is the way I would do it.

Dr. Straszheim. If you make it incremental, it doesn't cost you so much money in revenue for every dollar of increased capital spending that you get. But it seems to me that making it incremental is a lawyer's and accountant's dream. And I can just envision the new little companies being established that had, of course, no investment last year, so all of their new investment this next year is new and qualifying and so forth.

Temporary? I don't like the idea of making it temporary because, in fact, we have had, what, three different investment tax credits since 1962, and all of them were permanent, and they, in fact, get turned off at various different times. It lowers the cost of capital. It is a savings and investment item. It is too good of an idea to make just temporary.

Representative Obey. Okay. Let me ask a question on capital gains. I mean, I certainly agree, Larry, that if you are going to have a capital gains provision that it would be good to have the rates set in such a way so that you encourage investment on the part of high-income people. So I think that I am interested in your argument about the relative levels of taxation on the personal side for high-income people versus capital gains. But I am concerned about other problems that it raises.

I also agree if you are going to have one, it is better to reward long-term investments as opposed to short-term.

But let me ask you another question. Senator Sarbanes had an exchange with Mr. Boskin a year ago, and he pointed out that almost half of corporate finance is provided through debt, not equity; that half of equity is owned by nontaxable institutions such as pension funds; that much of the equity owned by households is held until death to avoid capital gains tax entirely; and, for most taxpayers, capital gains that are realized are generally held long enough and the tax, therefore, is deferred long enough that the burden is often quite small. And it is suggested, therefore, that capital gains taxation has minimal leverage in the cost of capital. The Congressional Research Service estimated that the same reduction of the cost of capital as the 30 percent capital gains exclusion would be achieved if interest rates fell by .05 percent.

Given that, Paul asked Boskins how much interest rates would have to fall to provide the same reduction to the cost of capital as the 30 percent capital gains exclusion. And Boskins estimated they would have to fall about 10 basis points rather than the 5 basis points as indicated by CRS.

Since Boskins testified, short-term interest rates have fallen about 500 basis points or 50 to a hundred times the reduction that would have

resulted from a capital gains tax, according to either CRS or Boskins. Long-term rates have fallen by 200 basis points or 20 to 40 times the effect of the capital gains cut.

I guess my question is: Did the fall in interest rates result in a substantial increase in business investment? If not, why would you expect the capital gains tax cut to have any more affect?

Dr. Chimerine. It won't. And I am strongly opposed to a simple reduction in the capital gains tax rate for a number of reasons: One, as you point out, I think the evidence clearly shows it will have a relatively marginal impact, at best, on new investment; second, in the long term, it will result in a sizable revenue loss; third, we will probably be rewarding old investments, which we don't need to do; and fourth, why have a reduction in the capital gains tax rate on selling old coins or something?

That is why I advocate a sliding-scale capital gains tax structure, because I think the most you can expect from a capital gains tax system is to shift the time horizon of investments. And I think that one of our big problems in this country is the way we use our capital. There is too much short-term financially oriented types of investments, speculative type investments, and not enough long-term investment.

We are way short on patient capital compared with our main foreign competitors. The reason I advocate the sliding capital gains tax structure is not because I think it is going to promote a lot more investment. I think that comes from the incremental investment tax credit. I think that what it would do is to shift the focus of investment more toward longer term and—if we define it properly—more toward productive type investments, and do so without losing revenues in the long term.

So that is why I would strongly support this and not just cutting the capital gains tax rate from 28 to 15, or 10 percent, or whatever, like some people advocate. It would not accomplish much, and it would widen the deficit in the long term.

Dr. Straszheim. I would like to see both the CRS and the Boskin calculations. I have not seen that data.

I would also say that what you really want to do is to increase investment in the future—you can't increase investment in the past. But there is one misconception, it seems to me, about the capital gains benefits or impacts, be they large or small.

It is true that it is basically the rich who have the capital gains, because the poor don't have any capital. But to the extent that you do get increased investment in the private sector, those companies hire people at all levels across the income distribution—poor people, rich people and the like. And I think that point is often missed in this debate.

Representative Obey. I think that is true. But let me point out that in 1985 in the Reagan Administration's study of the effect of the 1978 cut in capital gains tax, the Treasury Department estimated that the benefit of the cut would be an increase of 52,000 jobs. And the revenue loss to the Treasury, which would be the equivalent of $410,000 revenue cost

per job created, extrapolating from Treasury's numbers at the time when Treasury was being run by, I think, Donald Regan at the time—I guess it was Baker.

My concern is simply that I am for investment incentives, but just as I am suspicious of these on cheap job training programs that government often tries to do—great title, "Job Training," who can be against it—but when you look at actual delivery of the program, they are not quite so impressive.

I am also concerned that if we are going to find ways to create jobs that we find cheaper ways to create jobs than $410,000 dollars per job created. I could send my second son to Harvard graduate school, or law school, or any other place, and have enough left over to send the sons of my ten best friends for that. I think you have to be careful.

I have a lot of other questions, but I am out of time. Let me ask just one more. One of my other concerns about the budget is that I think this country is so hung up on the first hundred days business. And the way our system works is that presidents feel they have to expend all their political capital within the first six months or lose it. They are forced into a rush judgment on a whole range of issues. And you have to package things together and make all kinds of judgments which you might want to change three weeks later, but time doesn't let you at that point. If you try to change your mind three weeks after you have suggested something to the Congress, the press will kick the blazes out of you and say, he is waffling again.

So I think any president is damned if you do and damned if you don't. But we have this horrendous issue of health care. You can't deal with the budget without dealing with health care. Half the projected growth in spending in the next five years is simply due to our estimates about what the increased cost of health care will be to the public and, extrapolating from that, what the increased costs will be to the government. So we have to have some assumptions built into the truth on health care, but I don't have confidence in any numbers.

My concern is, we are told by a lot of people, for instance, we cannot afford to finance access for the 37 million people who don't have health care, because the cost of that will be $80 billion, or a little over 1 percent of the gross national product. And, yet, if we do nothing, the cost of health care through inertia alone will rise by about 2 percent of GNP through the rest of this century, if we are lucky. So I am really not sure how I think the Administration ought to fuse their health-care judgments into the budget. But I am concerned about overly optimistic assumptions on savings, because I think that no matter what government does there is such a tremendous ability for people within the health-care system to game it and to play games with the government, just like they play games with individual consumers. And you have so many smart lawyers running around who can help them do that that I think it is going to be tougher than blazes to actually reach the savings that we need to reach.

In my view, I would much rather say to the American public: Now, we are doing everything we can to control costs; these are going to be tough actions we take; nail them in, and also admit that if we are going to cover the costs of what has to be covered—including long-term care, because half of that is covered now by government and half isn't—it is really going to require a revenue source. I noticed with some surprise that the AFL-CIO, which for years has insisted on the principle of progressive taxation—they have opposed the idea of a consumption tax—they are now entertaining the possibility of a value-added tax to forthrightly finance health care.

So I would like to ask both of you what your judgment would be about that. And second, I want to ask another question about health care. One of the arguments you get against doing a lot is that people will say that we are just going to bail out the corporate sector. If the government winds up shifting a lot of costs to the government, that is simply going to bail out corporations, and you shouldn't have the public sector taking on those kind of dollars; let the private sector continue to wrestle with it.

And you have people saying that if I am a paper worker working in Wisconsin Rapids—and right now I have a great deal from Consolidated Paper— and I don't pay a blessed thing. Actually, I really do because I am paying it through the loss of my ability to get wage increases, because the company has to use every dime to finance exploding health-care costs. The argument has been, if you go to a system which finances health care, any portion of it, through an added revenue source, then how do you explain it to the guy who is working in a mill? Right now, he thinks he doesn't incur any costs from health care; he really does. But how do you recoup, not that I am suggesting that we ought to have a full-boat government plan, for instance; but if you did—and I am sure we won't—how would you recoup? How would you begin the process of putting the dollars, which workers are not getting today in pay increases, which companies are using for health care—if companies are relieved of the burden to pay for increases in health-care costs—how do you assure that the benefit flows into the pockets of the workers rather than being salted away in the company's coffers?

Dr. Chimerine. You have asked a number of questions. Let me respond to as many as I can.

First, I think you have to be careful about mandating more business costs in this environment. The key objective of this Administration has to be to start creating jobs again, and good paying jobs. And it is clear by now, even though I support many of the programs you do, including expanding coverage of health-care insurance, one of the big disincentives to hiring right now is health-care costs and other costs which have so significantly increased overall labor cost—not all of it is passed through lower wages. And, as a result, I think we better be careful about how quickly we expand it and pay for it. I think this is important in another context, because some of the people advising you to leave

things alone—the economy is doing better and is healthy—are pointing to the last few quarters when productivity growth has accelerated.

Partly, that might be a cyclical phenomenon, but it is happening at the expense of jobs. That is not sufficient. We need productivity growth that comes at the same time that we create new jobs, like we did in the 1950s and 1960s.

In the 1980s, we had a lot of job growth. Of course, they were low-wage jobs, and it happened without any productivity growth. So we didn't have improvement in living standards for most people.

We need an economy that has both good growth in productivity and creates new jobs simultaneously. I think you have to be careful about how fast you put programs in place, whether it is expanding health-care coverage, minimum wage increases, and others which will provide more disincentives to job creation. And, again, I say that as someone who is in favor of some of these programs, we have to be careful about it.

Whether we have a dedicated tax for health care or not, we need tax revenues. Even if we don't broaden health-care coverage, there is no way to get the deficit down without it to acceptable levels. And my advice would be not to have a dedicated tax. We will pay for that out of health-care cost controls and out of the general revenue increases that we will be implementing. But I think it will create hostility if we enact a tax on everyone to pay health care for those not insured, when others are getting their health care cut, when they are paying more of their own premiums, and when their wages are being squeezed. I don't know if you want to do it through a dedicated tax. Clearly, we are going to need revenue increases in the future to both bring down the deficits and to pay for whatever additional programs we put in place. Whether we should go to a national health insurance system, what the best solution to health care cost control is, I would be misleading you if I told you that I had enough expertise and had studied it enough to give you the best answer. My guess is that we are going to have to patch the system in place and slowly phase in coverage for those who don't have it. But beyond that, I have no constructive suggestions.

Dr. Straszheim. One comment about what Larry just said. We may decide as a society that part of the solution—maybe a big part, maybe a small part—of the deficit problems is more revenues. But that is not the only possible choice. It may be the best choice, but it is not the only possible choice.

We could resolve the deficit if we so chose purely on the outlay side. The value-added tax, as a separate source for financing health care—I don't like that *per se*—but I think the value-added tax is a much better way to raise revenue than the income tax, just as I believe an income tax is a better way to raise revenue than a wage tax.

And so, in that perspective, I would like to see us get started with a value-added tax, even if it is dedicated to this one area in the economy—health care—and then, perhaps, at some point in the future

broaden, it to other areas. There will be all kinds of differential impacts in terms of company programs and so forth as we contemplate these changes in health care, and I don't know what the solution is to this. But the idea that companies would salt some of this savings away—companies would use that money which they salt away to invest, and their equity price might rise, which would be of benefit to the equity holders. They would pay it out in terms of dividends to the people who are owners of the company. In the long run, that money still gets back to the economy in one way or another; and you need to try and figure out the kinds of income distribution effects that it has, which are very complicated.

Representative Obey. Not that I think President Clinton is considering anything like that, because I don't think he is, but I noted a note coming up on the radar screen from workers organizations. My point is simply that if you are to wind up having to finance any part of health care through something other than cost controls—and I personally believe that you will have to—if you are going to deal with the entire problem, I don't think we ought to play let's pretend on that issue. If you are, I think it is a legitimate concern for workers to say, look, if employers are going to be relieved of future growth and costs and if you want to finance that by taxing me, I am not very thrilled by that. I think that is the word you are going to get from most workers in this country. So I think, if you are going to consider that, you have to try to figure out what the mechanisms are to insure that that, in fact, doesn't happen. That is all I meant by that.

I also know from having discussed different options with a number of people in the Administration that they are certainly going to be far, far heavier on the spending cut side than on the tax cut side. I would dare to say that the congressional mail two months from now will contain a whole lot more letters from people objecting to specific cuts in specific programs than it will objecting to taxes that the President may be proposing either on them or on somebody else.

Let me thank you both for coming.

Dr. Straszheim. Could I say one other thing?

Representative Obey. Of course.

Dr. Straszheim. Given that there is going to be this uncertainty on health-care because the health-care task force is not going to have anything ready for a few months, perhaps there should be some effort to make some kind of a distinction in the budget, a special line just like there is in many of the budget documents on the S&L bail out, and so forth. I think we ought to be upfront with the public and realize that there is a great deal of uncertainty here. That way you could see what the budget and the health-care issue is versus the budget on the health-care side, and aggregate it together.

Representative Obey. I think, as a practical matter, what we need to understand when the President submits his State of the Union message,

he will have been in office a little over a month. So I think what you will get is simply an outline plan.

I would be flabbergasted if some of those specific plans don't change somewhat down the line. And, in fact, I would probably be disappointed if they didn't, because as the President has more time to put together other options and test reactions in the country, he will probably need to make some adjustments.

I suspect in the end, if this gets wrapped into a package which includes health care, we will have much firmer ideas about what those numbers on health care will be come June than we have right now. They may still not be firm enough, but they will be a whole lot better than we have now.

Thank you both for coming. I appreciate your time. This is simply an effort to try and walk through, in a very quick way, some of the thousands of choices that the President is going to be going through before he presents his State of the Union message and his budget to us. I think the sign that Mr. Carvel had on his desk is still the right sign—"The economy, stupid." In dealing with the economy, it is more than one deficit, it is four deficits. It is the budget deficit; and it is the investment deficit; it is the growth deficit; it is the family income deficit." And if we don't have a delicate balance in our attack on all four of those, we won't succeed in attacking any of them, including the big apple, the federal budget deficit.

Again, I thank you both for coming.

[Whereupon, at 12:20 p.m., the Committee adjourned, subject to the call of the Chair.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF LAWRENCE CHIMERINE

My name is Lawrence Chimerine. I am currently a Senior Economic Counselor, Data Resources/McGraw-Hill Inc., and a Fellow at the Economic Strategy Institute. I appreciate the opportunity to testify before the Joint Economic Committee on the current economic situation, and on appropriate policies to deal with both our short and long-term economic problems, as well as the federal deficit.

In sum, my views are as follows:

1. The U.S. economy has experienced an unprecedented period of near-stagnation which began in early 1989. This stagnation primarily reflects a reversal of the forces which produced the long expansion of the 1980s (e.g., the military and construction booms, the huge leveraging of the system, the consumer spending spree financed in part by tax cuts we couldn't afford, etc.), and the deterioration in long-term growth fundamentals during that period.
2. The economy has picked up some during the last four or five months. This upturn has lasted longer than any of the previous upticks which turned out to be false starts, raising hopes that stagnation is now over and that an acceptable recovery is underway. In my view, while some of the fundamentals have improved, there are a number of factors which suggest relatively slow growth is still the most likely outcome for 1993, and several significant downward risks still remain..
3. A short term stimulus package is warranted in order to insure agument growth and buy some insurance against the downward risks. However, I strongly believe that the short term stimulus package should achieve maximum "bang for the buck" so as not to significantly increase the deficit, and should simultaneously focus on the long term need to reverse our underinvestment. I thus believe that some forward shifting of infrastructure spending, cost effective investment tax credits, and a long term capital gains tax reduction, should be the major components of a stimulus package.
4. I believe the most serious economic problems in the United States are the sluggish trend growth in productivity, and the decline in the international competitiveness of the United States economy. It is vital that we implement a multi-dimensional national economic program designed to increase productivity and improve our competitiveness. This must be a government-led effort and should focus on increasing investment.
5. It is also essential that the Federal deficit be dealt with in an effective manner in order to free up more of our savings to finance more private investment in future years. The high deficits are already sucking the vitality out of the U.S. economy by squeezing out productive investment, by keeping real long term interest rates extraordinarily high, and by increasing our dependence on foreign capital. Gimmicks, such as a balanced budget amendment, will not work, and in fact may be counterproductive by leading to more complacency and by limiting the options for deficit reduction. The focus must be on entitlements, especially on the health and pension programs, on additional cuts in defense spending, and on some further cutbacks in non-defense programs—however, even after all that is done, the arithmetic clearly shows that some tax

increases will be necessary, especially in view of the need to increase Federal spending in some areas.

CURRENT ECONOMIC SITUATION

By now it should be clear to everyone that instead of a normal recession, the United States has experienced a long period of economic stagnation in recent years. This great stagnation of the 1990s has been caused by a number of factors. First, many of the forces of economic growth during the 1980s, such as the huge military buildup, the construction boom, the dramatic up-leveraging of the economy, a massive inflow of foreign capital, tax cuts we could not afford, loose lending standards, etc., have been at least partly reversed in recent years, thus holding back economic growth. Secondly, the underlying fundamentals for long term growth have deteriorated—in particular, both saving and investment rates have declined; trend productivity growth has been poor; U.S. competitiveness in world markets has deteriorated badly; the quality of education in the U.S., particularly at the elementary and secondary levels, has fallen; etc. Thus, as the forces of growth of the 1980s have been reversed, we had nothing to take their place because we did not build for the future.

There are five factors that I believe have been most responsible for extending the process of stagnation, and thus for preventing a meaningful sustainable upturn during the last several years despite the optimistic forecasts which have been prevalent.

First, the private sector has been in the midst of a trend toward deleveraging that began several years ago. Put simply, many corporations and individuals began to have difficulty servicing the debt that had already been accumulated. Many have balance sheets that are lopsided with debt, increasing the risks in their businesses or personal lives. Furthermore, the decline in the value of many assets, especially real estate, has aggravated these balance sheet problems. This ongoing deleveraging has been an obvious limiting factor on economic growth, especially in comparison to the 1980s when the increased willingness to borrow contributed as much as a half to one percent per year to the growth rate. It has shown up particularly in reduced demand for debt-sensitive products, such as autos, other consumer durables, housing, capital goods, and inventories.

Secondly, a significant disinflation trend has been occurring in the United States. This is most evident in declining property values, in extremely weak commodity prices, in slower growth in wage rates, and most important, in the difficulty that most companies in most industries are having in raising prices (many have been forced to cut prices). This trend toward disinflation has been the result of many factors, including widespread excess capacity, intense domestic and foreign competition, efforts to improve productivity, and buyers resistance. The effect of price restraint and weak volumes in most industries has been to limit revenues in a large number of companies to be extraordinarily weak—many have reported revenue declines for the first time in many decades. While economists focus extensively on real GDP and other such measures of economic activity, most companies run their businesses off revenues—the weakness in revenues, coupled with the absence of any meaningful recovery, has been causing the most widespread cost-cutting in the corporate sector that has been experienced in many years. This has been taking many forms, including additional efforts to cut inventories, cutbacks in capital spending, wage freezes, benefit cutbacks, and mostly, an extraordinarily high rate of job terminations. All of these are further restraining economic activity—the layoffs are doing so in two ways, by reducing household income, and by caus-

ing widespread anxiety regarding job security (which has caused consumer confidence to remain low).

Thirdly, widespread cost cutting also reflects the sizable deterioration in U.S. competitiveness in world markets during the late 1970s and 1980s. Many companies are being forced to cut costs in order to offset the elimination of their productivity advantages in order to remain competitive. While this may be beneficial in the long run, it amounts to a tradeoff between foreign demand and domestic demand in the short run.

Fourth, the budget imbalances at state and local governments have also become a major constraint on the economy. In particular, disinflation and poor income growth are restraining state and local government tax receipts at a time when rising medical costs, higher wages for government employees, federally mandated program increases, etc. are causing expenditures to rise. The result has been the largest fiscal imbalance at the state and local government level since the depression—this in turn has led to widespread expense reductions (including layoffs) and higher taxes.

Fifth, the construction and military booms of the 1980s have given way to sharp declines in these sectors—these are not only large sectors, but they have high domestic multipliers because of limited import leakage, causing a sizable negative effect on overall activity.

Following the long period of stagnation, the economy has clearly picked up in recent months. The faster pace of economic activity is evident in the national income accounts—currently available data indicate a more than 3.5% rate of growth in real GDP during the second half of last year. The improvement was heavily concentrated in retail activity, with expenditures for furniture, household appliances, apparel, and other goods leading the way. Traditional department stores, discount chains, and niche retailers all shared in this turnaround—it appears to have begun in early September, and except for a brief lull in November, has continued ever since. Housing has also been trending up.

Any assessment of the durability of the recent upturn obviously depends on the underlying driving forces. In particular, it appears that the initial factors were very untraditional, such as the late Labor Day, which shifted some school-related spending from August into September, and Hurricane Andrew, which was followed by a surge in spending to replace items damaged or lost. However, continued strong sales in December and January cannot be completely explained by these factors. It appears that a significant improvement in consumer confidence, primarily reflecting expectations (or hope) that the new Administration will address our economic problems and help create a sounder basis for future economic growth, coupled with the enormous pent-up demand for many goods following several very lean years, are primarily responsible for the higher spending levels.

However, there are a number of reasons to suggest that the acceleration in economic growth in the second half of last year is not likely to be followed by even stronger growth, and thus a more traditional recovery, during 1993. Consumer spending in particular is likely to slow somewhat in the months ahead, for the following reasons:

- While chain store sales been strong, other indicators of consumer spending have improved far more modestly. These include auto sales, restaurant meal consumption, household airline travel, etc.
- There is a significant chance that consumer attitudes will fall back again if the job market does not improve significantly, especially in light of recent announcements by many large companies of new layoffs and job

eliminations, and/or if confidence in the Clinton Administration begins to wane.

- While credit card usage has jumped sharply in the last several months, it is premature to conclude that the deleveraging of the household sector is over. Debt service has dropped sharply because of widespread refinancing, but the stock of consumer debt relative to income remains relatively high. The econometric evidence indicates that outstanding debt may be at least as significant in impacting spending patterns as are debt servicing costs.
- Income growth remains relatively weak, reflecting the minuscule growth in jobs as well as the continued deceleration in average wage growth (reflecting both wage restraint and the ongoing shift to lower paying jobs). Unless job growth begins to accelerate very soon' there will simply not be enough income to support significantly higher spending levels. And with continuing cuts in defense jobs; with construction employment still flat at best; with Federal, State and Local governments all still constrained by sizable budget imbalances; and with the health care sector (which has been the major source of new jobs in recent years) already beginning to anticipate health care cost controls which, might limit their new hiring, a major acceleration in job creation in the period ahead is not likely.
- The reduced withholding on Federal income taxes during 1992 will result in either smaller refunds or bigger tax payments for many individuals this spring.

In addition to the likelihood that these factors will hold down the growth in consumer spending, it seems virtually certain that export growth will contribute far less to overall economic growth during 1993 than in recent years. This of course reflects the recessions which are either already underway, or are now developing, in much of Western Europe and Japan. Germany in particular is in the midst of a sizable decline in economic activity, caused primarily by still high interest rates. And, given the lag in production and employment cuts relative to the decline in spending, some significant declines in output are likely in Japan in the months ahead. While U.S. exports to Latin America and some other regions will continue to grow, weak markets in Japan, Germany, and most other industrialized countries will cause a significant offset, resulting in only marginal growth in overall exports at best. This appears to be confirmed by weakness in the order books of many major exporters during the last several months.

Economic growth will also be constrained by the continuing drag caused by several of the longer term factors discussed earlier, such as the downsizing of defense spending, the continued weakness in commercial construction, still cautious bank lending, etc., all of which will prevent the normal contribution to economic recovery from several sectors of the economy. And, while inventories are relatively low, this reflects a deliberate effort on the part of many U.S. businesses to conserve capital, to cut financing costs, and to avoid holding too much inventory in a deflationary environment (real long term interest rates for producers of most commodities and other goods are still extraordinarily high) —thus, inventories are at best a neutral factor in the economic outlook.

On balance, therefore, I continue to believe that the most likely scenario for the period ahead remains very subdued growth, or a half-speed recovery. In fact, I expect economic growth during the four quarters of 1993 to be somewhat lower than during the second half of last year, probably in the 2.5 - 3.0% range. Furthermore, the downward risks are sizable; these include the possibil-

ity of even deeper recessions in major industrialized countries, and/or a possible sharp decline in consumer confidence.

DO WE NEED SHORT-TERM STIMULUS?

My own view remains that a modest, cost-effective stimulus package is still desirable because, as mentioned earlier, it is unlikely that the economy will strengthen considerably on its own. Furthermore, in view of how sharply the economies of Germany and Japan are weakening, the risk of a global recession is increasing—some insurance against that risk seems appropriate. In addition, as mentioned earlier, the job market remains very weak, and it appears that some fiscal stimulus might be helpful in producing new jobs. Finally, the weakness in the job market is causing significant hardship and pain for many individuals and families, requiring some short term actions to ease those hardships.

Thus, despite the recent more favorable economic data, a proactive program to stimulate the economy is needed and as will be discussed below, to simultaneously bolster our long-term growth prospects. The way to meet both of these needs is with an investment-oriented, countercyclical program that will dramatically increase our rate of investment in new, productive assets, thus helping raise our abysmal productivity growth and improving our competitiveness in world markets, while at the same time increasing jobs and economic activity in the short term. Our public and private investment needs are enormous—they include modernizing our capital stock, reducing our dependence on foreign oil, upgrading our infrastructure, and building communications and data-handling systems for the future. It is vital that any short-term program address these long-term needs, or very little will be accomplished—in effect therefore, I am suggesting that the short-term stimulative program be the first step in developing and implementing an economic plan to rebuild the U.S. economy on a long-term basis.

In my view, any stimulative package to address our short and long-term needs should avoid a significant widening of our mind-boggling structural deficits. Limiting any increase in the deficit would of course require creativity—it means that any actions that are put m place will have to produce a "big bang for the buck" by being targeted and focused, and/or, be temporary.

I would thus limit the package in size and in particular, reject the advise of those who are advocating a $50 - 75 billion deficit-widening package in the first year. My reasons are as follows:

- We cannot afford a large package—given the already horrendous outlook for the FY 93 deficit, adding $50 - 75 billion is outside the range of acceptability. This would likely spook the bond market and push up long-term interest rates, which would be counterproductive. The argument that "we will raise the deficit now but will get around to cutting it later" has been heard many times before by the bond market and is not convincing—the only way that the new Administration can show that it really is serious about dealing with the deficit is to demonstrate that right from the beginning.
- A big package isn't really necessary anyway because a carefully constructed cost- effective program can produce almost as much stimulus without adding too much to the deficit.
- I would especially strongly argue against a large broad based tax cut, because it would provide very little direct stimulus once those portions which would either be saved, used for debt repayment, or spent on imports are factored out; because it will do very little to address our huge

public and private investment needs; and because it would dramatically increase the deficit on an ongoing basis.

Instead, I suggest a more modest, but cost effective investment-oriented program including a large investment tax credit, but only on incremental investment, in productivity- enhancing equipment, over and above a base period. For any company, the base can be calculated as the average of investment during the last several years. Dramatically accelerated depreciation, or total expensing, on incremental investment would work just as well. Both would not only provide a big incentive at the margin, but revenues would not be lost for investments that were previously planned. Thus, if they do not stimulate new investment, there would be virtually no revenue loss to the Treasury; if they do, the increase in economic activity will generate enough added revenues to basically pay for the credit or accelerated depreciation.

It is also essential that we find ways to stretch out the investment horizon in the United States. Changing capital gains taxes can help shift the pattern away from the short- term, financially-oriented, speculative type investments that characterized the 1980's to badly needed longer term investment. However, to accomplish that, a much larger difference between the rates on short-term and those on long term gains would be necessary. This can best be accomplished by enacting a sliding scale capital gains tax structure, incorporating an <u>increase</u> in the rate on short-term gains, with the rate declining the longer the asset is held (to perhaps near-zero for five years or longer). Furthermore, the relatively low long-term rate should apply only to investments in productive assets, and not to vacation homes, old buildings, etc. And it should also apply only to new investment—it is unnecessary to reward those that have been made in the past.

I also suggest an increase in the top marginal tax rate, or implementing a third marginal tax rate on relatively high incomes. While many advocate this on the grounds of restoring some fairness to the tax system, there is an even stronger reason to do so. In my view, such an increase would be pro-investment—it, coupled with a decline in the capital gains tax rate on long-term, productive investments, will encourage relatively high-income individuals to shift some of their safe investments into the riskier, long-term investments that the country needs. In addition, it would encourage more employees to enter the world of entrepreneurship. Both will come about because the changes suggested above will produce a large difference between the tax rate on long-term capital gains and that on short-term income (and short-term capital gains)—it is this difference, rather than just the level of the capital gains tax rate, that is important for venture capital, business start-ups, and other risky long-term investments. While a higher marginal rate might reduce new national savings (this in fact is debatable, because if personal savings do fall, it will at least partly be offset by a reduced Federal deficit), the key is to make more effective use of the savings already in place. The current low marginal tax rate and the relatively high capital gains tax rate discourage risk-taking and long-term investments.

The country also desperately needs more public investment. A much-needed rebuilding and upgrading of our infrastructure is essential if productivity growth is to be increased—to maximize short term stimulus, programs now on the drawing board should be accelerated. In the long run, some of this can be financed without enlarging the deficit by privatizing a modest amount of government-owned energy facilities, such as the Tennessee Valley Authority and the Bonneville Power Authority.

Combined public-private investment initiatives could also provide an immediate boost to the economy. For instance, new high-speed rail links devel-

oped by Federal and State public entities could be linked to new private investments in fiber optic communications. New highway construction could also be coupled with building new fiber optic communications alongside highways. The gains from such infrastructure development efforts would have an important long term impact on the economy.

To help improve the investment climate, some stimulus for consumer spending should be provided, as long as it does not significantly widen the deficit, and is not offset by other restrictive measures. This can be accomplished by adjusting the Social Security wage ceiling and tax rate in a revenue neutral manner. Such a change would reduce taxes for a large majority of American families (and those which need it the most), would make the tax structure less regressive, and would provide a modest amount of stimulus by shifting income to those who would spend more of it. I also suggest that we further extend and widen unemployment benefits, and other safety net programs that were cut back during the 1980's, not only as a humane measure, but because the marginal propensity to spend out of these benefits is relatively high.

Additional stimulus can come from a proactive program designed to reduce import penetration. In particular, the Japanese continue to import virtually all the parts they use in their U.S. auto, TV and other plants, despite the fact that at current exchange rates, U.S. parts producers have at least a 10 - 15% cost advantage. Cutting the trade deficit in this manner can help stimulate economic activity, again without any negative effect on the deficit.

Finally, modest regulatory and capital reforms that can reduce the disincentives of banks to lend to small businesses (they have been most impacted by the credit crunch, and have few other sources of capital), can also help stimulate the economy in the short term in a manner that is consistent with our long term objectives.

The program outlined above will provide short term stimulus and thus improve the job market, and do so in a manner consistent with our long term needs—it also addresses the fairness issue more effectively than many of the proposals now on the table, and would avoid an increase in the budget deficit over the long-term.

DEALING WITH LONG-TERM PROBLEMS OF UNDERINVESTMENT AND LOW PRODUCTIVITY GROWTH

The ultimate goal of any effort to restore economic health is to raise living standards for the vast majority of the population, and in so doing, significantly improve prospects for the next generation. This can only be accomplished by achieving a much higher rate of productivity growth than the less than one percent average between 1973 and 1991. An acceleration in productivity growth is also vital for a number of other reasons. First, it is clear that the major factor in the loss of international competitiveness of the United States has been an erosion of the productivity advantages that most U. S. industries previously enjoyed. This has resulted not only in the loss of U.S. market share in an increasing number of global industries, and enormous trade deficits, but has created downward pressure on the number of high-paying manufacturing jobs, on average wages, and on the U.S. dollar, all of which have reduced real wages and living standards for many Americans. Secondly, the lack of significant productivity growth in non-tradable sectors has also prevented any meaningful improvement in living standards for workers in those industries—only if productivity picks up can this trend be changed. Finally, only a meaningful improvement in productivity growth can produce the necessary economic growth

to enable us to address the serious social problems which exist in this country, including drug abuse, illiteracy, crime, social decay, etc.

It is important to note that what is required is not merely a one-time increase in productivity, such as has occurred in many companies as a result of staff cutbacks or closure of relatively inefficient plants, or a cyclical recovery in productivity such as now appears to be taking place. What is needed is an acceleration in the trend in productivity growth, or repetitive year-after-year gains in productivity, such as this county experienced in the first thirty years after World War II, and such has been occurring in Japan and many other countries. And it must be economy-wide—improvements in productivity in some industries which take place primarily as a result of outsourcing and other measures which shift the problem elsewhere will not effectively solve most of our problems. Finally, it is also important that acceptable gains in productivity take place in a relatively fully employed economy—improvements in efficiency, or downsizing, which reduce employment in some industries (as is now occurring) is only acceptable in an environment where the demand for labor is rising sufficiently in other industries to keep the economy fully employed.

What is most disturbing is that it is difficult to expect productivity growth to accelerate on a trend basis, and our relative competitiveness to improve, in light of the following:

- Our net investment rate is half of Japan's, and far below that of other major competitors.
- Our national saving rate is at a record low level, despite the so-called supply-side savings incentives.
- Our business sector is highly leveraged, which is causing additional downward pressure on non-defense R and D (which has already fallen below the rates in Japan and Germany).
- Declining SAT scores and other measures show that the quality of education at the elementary and secondary school levels continues to deteriorate, falling further below our major competitors.
- Our infrastructure continues to decay, reflecting the neglect of the 1980's.
- No systemized effort is underway to improve job training and provide the needed skills for the 1990's.

I strongly believe that a national economic plan to restore trend productivity growth, competitiveness, and improving living standards is absolutely essential; these will not materialize without such a plan. The focus of the national economic strategy should be as follows:

a) To significantly increase the amount of productivity-enhancing investment, so that the capital stock per employee, in both quality and quantity, will begin to approach our major foreign competitors;

b) To bring about a dramatic improvement in the skills of our work force, both by improving the quality of public education, and increasing public and private job training;

c) To reverse the slide in United States technological superiority by beefing up basic research, and by speeding up the process by which new technological breakthroughs are translated into new products and into higher productivity.

The economic strategy should be based on the principle that what we make as a country is important. In particular, I strongly reject the notion that all goods and services are alike—that there is no difference between wood chips, potato chips, and semiconductor chips. Quite the opposite, it is extremely im-

portant to make certain that the United States has a major presence in those industries which represent the growth markets of the future, if in fact we want to experience strong economic growth; in those industries and products which have high multiplier impacts on the rest of the economy; in those industries and products which generate high value-added and thus produce high paying jobs; and in those industries and products which are leaders and drivers of new innovation, and without which the process of new technological development will be set back. Thus, we cannot accept another period of economic growth accounted for by the construction of empty office buildings, Patriot missiles, and the like, while more and more of our key industries are permitted to deteriorate.

This does not mean significantly greater economic management of the economy, or that the Federal government should consistently pick winners and losers. But, some industries are important for the well being of the country as a whole, so that if they are not permitted to develop, or if certain existing industries are permitted to go under, the entire economy will lose. Thus, permitting the development of some key strategic industries will be a win-win situation for the economy, rather than coming at the expense of other industries, because they will help create a higher employment, higher wage, more vibrant economy, thus increasing the demand for other goods and services as well.

The Federal government should have the following role in bringing about more investment in the years ahead:

a) To set targets for various measures of economic performance. Included should be desired rates of saving, investment, and nonmilitary R&D; average SAT scores; health care costs and health care inflation; and productivity growth and overall economic growth, for the next ten years. These measures include both ends in themselves as well as means to achieving those ends—thus, while the ultimate objectives are productivity and economic growth, it is necessary to specify goals for savings, investment, R&D, etc., in order to achieve desired growth in economic activity.

   These goals should be monitored on a year-by-year basis, and if the trends are unfavorable, policy changes should be considered to increase the chance of achieving them. It is not only important for the Federal government to develop these quantitative targets, but it is also important for them to be presented to the country at large, so that individuals, corporations, etc., have some understanding of where we want to be.

b) The Federal government should act as an example for the private sector by channeling as much of its own funds into productivity- enhancing expenditures as possible, by eliminating waste and inefficiency, etc. A significant change in its own priorities seems in order. Any realistic strategy will require increased Federal funding for research, for improving the quality of education, etc. An increase in public investment, both to repair and modernize the existing infrastructure must also be part of any successful economic strategy.

c) It is important for the Federal government to recreate the concept of the national interest. Thus, we can no longer tolerate behavior that might enrich some selected individuals but which damages the national economy. When situations such as this arise, it is legitimate for the Federal government to make some effort to reverse them by jawboning or by other means.

d) It seems clear that one additional role of the Federal government will be to act as a catalyst in achieving our economic objectives. Thus, there

will be times when the Federal government should bring various segments of the economy together in order to help them reach some agreement which might be in the national interest, or might facilitate some event or direction that might be helpful to the national economy.

e) Perhaps the most basic function of the Federal government is to create the proper business environment. This includes effective macro policies to increase saving and investment to bolster productivity and competitiveness, and taking prudent steps to reduce the budget deficit (see below) in order to cut the cost of capital to the private sector. Other policy measures, such as those which will encourage more private R&D, which would slow the growth in health care costs, etc., also need to be implemented.

f) Finally, micro policy changes will also be necessary, such as relaxing anti-trust laws to permit more industry consortiums (both on the research as well as the production side), providing assistance to key emerging or existing industries, more vigorous enforcement of existing trade laws, developing a trade policy more in tune with today's economic realities, etc.

DEALING WITH THE DEFICIT

As indicated earlier, policies to reverse the underinvestment of the 1980s must be accompanied by a meaningful program to dramatically reduce the budget deficit. The deficit outlook at the present time can only be described as frightening—current projections show that the unified budget deficit will drop only marginally below $300 billion per year by the middle of the decade. Furthermore, deficits are likely to begin rising again as we approach the end of the decade, even with the inclusion of sizable surpluses in the Social Security trust fund—when these trust fund surpluses begin to be paid out in benefits early in the next century, the unified deficit is likely to skyrocket unless steps are taken to reverse current trends.

This outcome is unacceptable. ft should now be clear that these enormous deficits do matter. They have already begun to slowly suck the vitality out of the U.S. economy by squeezing out productive investment, keeping real interest rates extraordinarily high, increasing our dependence on foreign capital, reducing the effectiveness of fiscal policy as a stabilization tool, and by creating pressures on those Federal programs that are needed to help build our economy for the future. In my view, the urgency to reduce the deficit is even greater now than it was in previous years, for the following reasons:

1. Personal savings have declined in the 1980's, despite the supply-side incentives, thus reducing the supply of domestic savings.
2. The flow of capital from Japan, Germany, and other parts of the world, which helped fund our deficits in the 1980's when we were the world's major capital importer, has slowed dramatically. This is resulting from the fact that many of those countries are no longer generating surpluses to the same degree as they were previously, and because other parts of the world have become large capital importers as well.
3. It is clear that reversing the weak trend of productivity and improving our international competitiveness will require substantial increases in private investment. High real long-term interest rates, caused largely by massive deficits at a time of lower domestic savings and a reduced inflow of foreign capital, will only dampen such investment, exactly the opposite of what is needed.

In effect, the Federal deficit must be gradually reduced in order to free up more of our limited savings to finance private investment, and to further reduce real long-term interest rates. Furthermore, as discussed earlier, it is essential that government priorities be changed at the same time that deficits are reduced—more federal spending is needed for those public investments that will both directly improve U.S. productivity, and help begin to rebuild the U.S. economy. The challenge of course is how to do both—across the board spending cuts, or any other method that does not result in the necessary change in priorities will not be sufficient if our objective is to get the U.S. economy on the right course for the future.

Any effective program to deal with the deficit must understand how these huge deficits developed in the first place. Today's massive deficits, as well as those during the 1980's, are directly attributable to the misguided economic policies that were implemented in the early 1980's under the banner of supply-side economics. Multi-hundred billion dollar deficits for as far as the eye can see were completely predictable at that time because:

1. The mythical spending cuts that would supposedly result from the elimination of waste, fraud, and abuse were enormously exaggerated from day one.
2. The incentive effects of supply-side tax cuts were inconsistent with most empirical evidence, and thus were enormously overstated.
3. Thus, not only did the big military spending increases and large tax cuts put massive pressure on the deficit, but the anticipated spending offsets, and the added revenues from economic growth, could never and did never materialize.
4. Furthermore, the explosion in health care costs and other entitlements have pushed the cost of those programs far beyond earlier expectations.
5. The problem was worsened by the use of extremely optimistic (and usually inconsistent) economic assumptions, understatement of program costs, budgetary gimmicks, etc. which enabled projected budgets to be in balance when in truth there was virtually no possibility of that occurring. The problem began to feed on itself because the horrendously inaccurate projections, created an attitude of indifference and neglect and thus prevented any real solution to the deficit problem, causing the national debt to skyrocket and interest on the debt began to grow at an enormous rate.

Cutting the deficit in half over the next five years from current projected levels in my judgment represents a reasonable initial goal. I strongly advocate that the short term stimulus program be coupled with enactment of program changes which will be phased-in in the years ahead in order to achieve that objective. Doing so would create a win-win-win situation for the new Administration—it would provide the short term stimulus that the economy needs; it would include the incentives for private investment, and increased public investment, that are needed to improve our long term economic prospects; and, by including meaningful deficit reduction, could help bring long term interest rates down in order to further stimulate long term investment. In order to accomplish this, the deficit reduction measures must be substantial, not only to bring about the desired cut in the deficit, but in order to help pay for the increases in public investment, tax credits, and other measures to increase investment that the Administration will likely advocate.

I believe that the following considerations are most important for a meaningful and desirable deficit reduction program:

1. Spending cuts should be the top priority. In view of the large cuts in non- defense discretionary programs in the 1980s, and given the need to increase spending in some of these areas, it is unlikely that huge savings will be realized from this sector of the budget (although, many individual programs should be scaled back). Thus, spending cuts must come from additional reductions in military spending, from an effective health care cost control program, and from slowing the enormous growth in the entitlements, especially the pension and health programs (the growth in public health care spending has to be slowed down both by controlling health care inflation, and by limiting benefits to those who don't need them). I would suggest that the concept of entitlements is no longer something that this country can afford. All the so called entitlement programs must be slowly converted to means testing, either by scaling back benefits for upper income and high wealth individuals and/or by increasing taxes on those benefits. We should reduce (not eliminate) benefits for those who could do with less—households and individuals with modest means should be spared. Furthermore, consideration should be given to further extending the retirement age for full benefits. Scaling back of health and pension benefits should not apply only to entitlement programs—public employees are now receiving extremely generous benefits which are no longer affordable. Finally, I would suggest that any reductions in social security benefits be earmarked for investments to build our future, especially for education and other programs which benefit primarily younger people. In effect, we would be reducing benefits for the elderly to be used to make a better life for their children and grandchildren.
2. Deficit reduction must be fair. In particular, it is now well documented that most of the benefit of the tax cuts of the 1980s went to those in the upper income groups—in the mean time, large social security tax increases and budget cuts have significantly reduced after-tax incomes for many low and middle income families. Thus, it is important that deficit reduction be structured in a way that the impact is greatest on those who can afford it. Many will make the argument that increases in taxes on upper income individuals will create huge disincentives for savings and investment and thus would be counterproductive—however, as we learned in the 1980s, these arguments are exaggerated. Furthermore, the economy can not function effectively when a large and increasing share of the purchasing power and wealth is concentrated in relatively few hands—this holds down demand and thus will prevent long term growth.
3. The arithmetic is very clear—even with the phasing in of entitlement reforms and some additional cuts in defense and non-defense discretionary programs, some tax increases will be needed in order to reduce deficits to acceptable levels. The assertion that the problem is not on the revenue side because tax revenues have actually increased as a result of the tax cuts of the early 1980's is utterly ridiculous. Both personal and corporate income tax collections as a share of income and profits respectively are far below where they were a decade ago—total tax revenues are roughly at the same ratio of GNP as they were prior to the enactment of the supply-side program primarily because of the big increase in Social Security taxes enacted in the mid-1980s, and because of other tax increases enacted along the way.

In my view, increased revenues should come first from eliminating counterproductive tax expenditures (incentives, exemptions, etc.) now in place, and

then secondly, if more revenues are needed, from increasing taxes in a progressive manner on activities that we want to consume less-of. Thus broadening the tax base should be considered before across the board tax increases. In the former category, some candidates are the following:

- eliminating or scaling back the interest deduction on mergers and acquisitions
- scaling back the deduction for corporate advertising expenses and/or for corporate entertainment.
- a lower limit on the mortgage interest deduction than is now in place
- taxation of a portion of corporate health care insurance premiums (this may also be helpful in controlling health care costs)

If tax increases are necessary, I advocate the following:

1. an increase in the top marginal tax rate
2. a sales tax on all energy consumption
3. an increase in the excise tax on alcohol and tobacco

I have one concern, however, regarding deficit reduction. No one can be overly confident with respect to the economic impact of deficit reduction over the next several years, especially if the rest of the world remains weak. Thus, there is a reasonable concern that cutting the deficit in half during the next four or five years can at some point push us into another recession, or keep economic growth so low as to prevent any meaningful job creation. This would be unacceptable. Some economists are advocating that deficit reduction be coupled with continued easing by the Fed in order to overcome the fiscal drag. However, given the high debt levels, cautious lending policies, and high commercial vacancy rates, and the already extremely low level of short term interest rates, it is not clear that additional easing would provide enough stimulus to the economy to offset the deflationary effect of spending cuts and tax increases. Thus, I suggest that the deficit reduction program be accompanied with an "escape clause" in the form of a minimum level of GDP or employment growth, or a threshold unemployment rate, beneath which future installments of deficit reduction will be delayed or scaled back in order not to create an even weaker economic environment. This is particularly important since the current level of economic activity is so low that the economy is likely to be underutilized for many years adding fiscal drag when the economy is growing very slowly would not be desirable.

One other economic policy issue. There are many who are advocating a major shift away from long term Federal debt financing to more short term financing in order to reduce interest expense and bring long term interest rates down. While in principal I agree, I believe such a shift should be limited in scope. First, too large a shift would likely force an increase in short term rates at a time when those rates have already moved up somewhat, and when an economic recovery could potentially cause more upward pressure—this would obviously limit the interest saving. Secondly, it might be viewed by the markets as a gimmick or substitute for real action on the deficit. Thirdly, it would require the government to refinance far more frequently, which could be disruptive to capital markets.

Despite the urgency of reducing future budget deficits, I am strongly opposed to the enactment of a balanced budget amendment. In my judgment, it is simply another gimmick like those that have been implemented in the last six or seven years, beginning with Gramm-Rudman, which have had very little, if any, impact. It will not only be an ineffective tool in dealing with the problem, but in my view is simply a way to attempt to avoid what will be difficult

choices, and place the blame for any unpopular spending cuts or tax increases on a mechanical formula rather than on Presidential or Congressional decisions. In brief, my concerns, are as follows:

1. Which budget is to be balanced? Is it the structural budget deficit, the unified budget deficit, the on-budget deficit, etc.? Should government investment be included or excluded? And over what time period? Answers to these and similar questions are not intuitively obvious.
2. It is likely to encourage even more use of optimistic forecasts, program underestimation, moving programs off-budget, and other similar techniques in order to avoid the tough decisions that will need to be made to actually balance the budget. Thus, the balanced budget amendment has the potential of making the budget process even more flawed than it was in the 1980's. We are also likely to see the adoption of more gimmicks that produce short-term revenue gains at the expense of revenue loss beyond the balanced budget period, which will simply make the long-term problem even worse.
3. There are times when a balanced budget may be undesirable. These may include periods of recession or slow growth, wartime periods, situations when domestic emergencies might exist or when increased foreign aid may be desirable, etc. In my view, it will be difficult to plan for all these contingencies in a balanced budget amendment, and any effort to offset these factors will be harmful to the economy.
4. In my view, it will probably make it more difficult for us to deal with our other critical budget problem, namely reorienting our priorities, because the tendency will be to look for the easiest ways of cutting the deficit, rather than those that are best for the economy.
5. What if, in fact, a balanced budget isn't achieved because the economic assumptions turn out to be incorrect, even if they were reasonable in the first place? How do we make adjustments for it? Who gets penalized? These are also difficult issues that would have to be covered.

It is also important to remember that the Federal budget, by its sheer size, and because of its role as a stabilization tool, should not be considered in the same way as an individual state or local government.

In my view, absent the will, absent caning about the future of our country, and absent the necessary leadership, the probability of this process actually taking place in a realistic manner will not be enhanced by a balanced budget amendment—in fact, as mentioned earlier, it could make the situation worse by encouraging even more gimmickry and fraudulent budgeting. It is not possible to legislate leadership, courage and caning-these are the bottom line reasons why the deficit problem has not been addressed until now.

PREPARED STATEMENT OF DONALD H. STRASZHEIM

I. INTRODUCTION

I am pleased to again appear before the Joint Economic Committee to discuss the current economic situation and some of the policy options facing the country. I appear here on my own behalf, and the views expressed below are my own, and do not necessary represent those of my employer.

II. THE NEXT FOUR YEARS

The start of a new Administration gives the nation a chance, only once every four years, to reassess, to take a somewhat longer-term perspective, to contemplate the relationship between the economy and economic policy. It is the following questions to which I hope these hearings attend. Hopefully this testimony will put a few of these questions into a useful perspective.

- Just how strong is the U.S. economy at present, and what are the prospects?
- How much new fiscal stimulus should be applied, and, if any, if what sort?
- Just how worrisome are the ever-growing Federal budget deficits?
- What should be done to reduce them, and at what pace?
- What should be done about health care, the greatest irritant in the Federal budget, and, arguably the single most important issue facing all Americans in the 1990s?
- How seriously should a fundamental change in the tax code be considered which would reverse the upside-down incentives in the present system, substituting a system which would encourage people to save and invest instead of consume?
- How differently will an economy be positioned and what will be its prospects in the 21st century if we move towards budget balance by raising taxes to the spending line—or by reducing spending to the tax line?
- Is total dominance of the Federal budget by payments to individuals—and even greater dominance in the future under current policies—healthy for our economy?

III. THE CURRENT ECONOMIC SITUATION

The U.S. economy suffered an approximately average-sized recession from June 1990 through March 1991. Since then the economy has been growing although at the slowest and most sluggish recovery rate in the postwar era. The recession was an unusual one in character, and economic recovery has been slowed by a variety of structural problems which are quite separate and distinct from the traditional cyclical ups and downs. The economic situation now looks quite different than it did in mid-1992. The current prospect is for slow growth in 1993 and 1994.

The 1990-91 Recession:

The U.S. economy fell into recession in June 1990, and emerged, haltingly, from that downturn in March 1991. The cyclically sensitive sectors of consumer durables, housing, and capital spending fell as usual. But there was no major inventory component to this cycle, unique in the postwar era. But this recession was quite different from many of our postwar recessionary episodes. It did not stem from a period of excess aggregate demand with an inflationary spike which was met by a contractionary monetary policy meant to cool-off the

economy. Rather the economy fell as a result of a host of structural problems which had been building for many years.

Structural Problems In The Economy:

The structural problems, listed below, which gradually developed during the 1980s gave the 1990-91 recession its particular character. They have kept the recovery so subdued that many observers still cannot distinguish the current recovery from the prior recession.

- Consumer Leverage: The consumer sector became very highly leveraged in the decade of the 1980s, and when income growth ended, the weight of this debt quickly halted consumer spending. Much progress has been made in deleveraging the consumer sector over the last two years, but this process is not yet complete.
- Business Leverage: The business sector also became highly leveraged in the decade of the 1980s as is well known, and this process too was halted by the mid-90s economic weakness. Again the business sector has been deleveraging at a rapid pace, but that process also is not complete.
- International Weakness: Expanding export markets were important to the U.S. economy in the last half of the 1980s but weakness around the world arrested the growth in our export markets and accordingly in our economy. (Admittedly, this item has both a structural and a cyclical component). At present, Europe and Japan are still declining, and their economies will not help ours until 1994.
- The Federal Budget Situation: With the chronic and ever growing Federal budget deficits, the opportunity to apply a large and timely dose of discretionary fiscal stimulus was missing. Indeed at that time the focus was on long-term budget repair. This lack of fiscal discretion when needed is an important argument for bringing the Federal budget nearer to balance so that this avoidable problem does not present itself again.
- State and Local Budget Dilemma: State and local governments' budgets increasingly have fallen farther out of balance, and all over the country governmental units have been raising taxes and lowering spending—a drag on the economy.
- Commercial Real Estate Excesses: Commercial real estate was badly overbuilt in the decade of the 1980s. That sector has been retrenching sharply for years and that process has many more years to run.
- The Defense Decline: The defense sector has been contracting for several years after the big buildup in the early 1980s, and even before the collapse of Communism. The defense sector decline is also far from complete.

This listing, not exhaustive, does indicate the nature of the problems which have confronted the economy in the last several years, and they have importantly kept the recovery painfully slow.

By most any measure, this recovery has been the slowest in the postwar era. The average real growth rate in the first six quarters of recovery is 6.4%. This time our recovery rate has been about one-third as fast. Other measures (employment, industrial production, personal income) reveal the same phenomena.

Spring 1993 Versus Mid-Year 1992:

While data is now just coming in for January, 1993 looks to be off to a good start. The economy has improved sharply since mid-1992. Real GDP rose

at a 3.6% rate in the second half of 1992, quite a good growth rate in historical context. Capacity utilization in the industrial sector rose from 78.6% in June 1992 to 79.3% in December 1992. The National Association of Purchasing Managers survey has risen from an index of 48.7 in September 1992 to 58.0 in January 1993. The index of leading indicators rose in each of the last three months of 1992. Consumer confidence (or sentiment) has risen by roughly one-fifth in the last three months. Housing starts and the sale of both new and existing homes are up modestly, and better housing affordability suggest further advances are ahead. The Christmas selling season in the retail business was a reasonably good one. The inflation rate is still down in the range of 2.5 to 3%. Short-term interest rates are around 3%, the lowest in a generation. And productivity advanced by 3% in 1993, its best performance since 1975.

But missing from the above recitation is clear and convincing evidence of a solid recovery in jobs. Weekly unemployment insurance claims are down about 20% since mid-1992, but remain at troubling levels. High visibility corporate layoffs continue, and many of the layoffs announced in recent months have yet to be fully implemented suggesting an ongoing weak jobs picture. Companies, uncertain about the future, burnt by a persistently weak economy, and alarmed at the possibility of new cost increases mandated by Washington, are simply unwilling to take on the permanent commitment of writing another payroll check every month, taking on the health care burdens, and all the rest. Alleviating the above concerns will come slowly, not quickly.

Perhaps most encouraging is the length of the average workweek, as high in January 1993 as it has been since the 1966-67 overheated economy in the midst of the Vietnam War mobilization. Soon, increases in orders and output will be met by increased hiring, a positive and welcome signal to labor market participants.

A significant portion of the recent consumer sector spending growth has been fueled by a decline in the savings rate. This cannot last. Until income hour employment rises more rapidly, the consumer sector—two-thirds of the economy—will remain in jeopardy.

The 1993-94 Outlook:

The prospect is for real growth in 1993 to approximate 3%, lower than the 1992 second half but positive nevertheless. Low inflation (around 3%) and low short-term interest rates (around 3% as well) should accompany this modest growth. Corporate profits and earnings should increase by something like 20% in 1993, the result of a major decline in interest expenses and the cost cutting and restructuring of recent years. With neither demand pull nor cost push pressures emerging to aggravate the inflation rate, 1994 promises to be a decent year as well. Absent some external surprise, growth and inflation both in the 3% range are plausible.

Germany and Japan, the other two most important economies in the world, are now both experiencing western-style recessions, and GDP growth is likely to be negative in both countries this year. Both also, however, are cutting interest rates and growth in 1994 in both cases should be higher than in 1993.

IV. POLICY ISSUES

While the economy has done better over the last half year, the U.S. economy's performance during the last few years has been substandard. We face a host of policy problems, but in general, the solution to our problems is not mysterious—it is just painful. In the Federal budget, we are spending $5.00 for every $4.00 of tax receipts, with the future looking even more unbalanced. Official budget estimates for years have been unbelievable leading to enormous

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public cynicism about our government, its leaders, and internally all policy initiatives. Not only is government spending badly outrunning receipts, but that spending is increasingly public "consumption" not, public "investment". Policy needs to take a longer term rather than a short term perspective. Our budget process is imperfect and could be improved. The ever-growing budget deficits have been spawned by spending taking a greater share of GDP, rather than by receipts taking a lesser share. Any deficit repair measures need to clearly consider the relative importance tax hikes versus spending cuts. Any current stimulus should be thought of merely as an insurance policy, not as an effort to increment our already satisfactory growth rate. And we need to increase savings and investment in the private sector in order to finance the job creation of the future.

Budget Estimates Of The Presidents:

The official budget estimates of the U.S. government have systematically been too optimistic for the last two decades. Year-after-year great progress is envisioned, and year-after-year it does not come to pass.

But the latest (1992 and 1993) budget estimates show an alarming new trend. Not only do they never approach budget balance, but they only show improvement for a few years before the budget again begins to deteriorate in the "out years", reaching even larger deficits.

In part, the projected worsening budget performance is because the economic assumptions which underlie the budget have become more realistic in recent years (a plus). This portrays as a consequence a weaker revenue path and a higher outlay path. Hence, the worsening budget performance.

But more importantly, the deterioration reflects the ever increasing importance of transfer payments in the budget and there ongoing escalation.

Deficits Year-After-Year:

While up and down cyclically over the years, Federal receipts have stayed remarkably constant at about 18% to 20% of GDP since 1960.

Outlays on the other hand have experienced a jagged but clearly rising profile and are now near 24% of the economy. The ups and downs in both receipts and outlays are the product both of discretionary changes in the laws on taxes and spending, and are due to the inter-workings of the economy and the budget over the business cycle.

Figures from 1993 through 2003 generated by the Congressional Budget Office (February) assuming an extension of current law—indicate the deficit rising to almost 7% of GDP by 10 years hence in 10 years.

While there is no natural role which that suggests that either receipts or outlays should be some particular share of the economy, it is clear that the cumulative result of our past decisions has been to leave receipts flat as a percent of GDP with the rise in outlays as the primary cause of the increase in the budget deficit.

Increasing Employment:

The public is acutely aware of the unsatisfactory condition in labor markets, and there is no disagreement with the Clinton Administration's effort to increase employment—an in a hurry. Lasting job growth in our economy will come from the private sector—not from the public sector. Companies hire employees because they believe they can take more in in revenues than they spend on employee. As tax hikes are contemplated to reduce the deficit in the long run, that taxes are costs to companies should be kept in mind. An increase in the minimum wage for all of its other purposes increases the cost of labor to

employers and will hurt the employment increasing efforts of the new Administration. Conversely, any successes in cost containment in the health care area will be a major plus.

A Stimulus Package:

The economy is presently less than fully employed, with an unemployment rate over 7% and with capacity utilization under 80%. And with the inflation rate under 3%, any risks to a counter cyclical stimulus would seem modest. It is also true, however, that the economy grew nicely in the second half of 1992 and still appears to be advancing at an above average rate at present. In addition, sometime would pass between a fiscal stimulus being decided on and its actual impact on the economy.

My own enthusiasm for a stimulus package is now at best lukewarm and clearly is less than it was in the summer of 1992. The economy is no longer languishing. A 1993 stimulus package of perhaps $30 billion would probably be difficult to find five years in the future. This is a $6 trillion economy. It is hard for me to imagine that our economic problems can materially be alleviated by the Federal government borrowing and spending $30 billion more. I believe that the public's mood is that the government's attention would be better focused on resolving our long-run structural deficit problems than on attempting to lift the economy with some short-run quick fix.

Deficit Reduction:

The most important problem we face over the long run is our ongoing and increasing unwillingness to conduct our fiscal affairs anywhere near balance. Our budget problems are not properly characterized as a crisis; they are a chronic condition. We increasingly use more of our total national savings for public dissavings, meaning that less is available for the private sector to invest and create job opportunities. A particular budget deficit reduction target is not especially important. What is important is for the public to understand that the government has a credible, long run deficit reduction plan in place and that it will be pursued. To put off that deficit reduction effort for one more year, sacrificing it to the near-term attraction of counter-cyclical fiscal stimulus will be a difficult proposition to sell to the public. The public has heard such promises of deficit reduction next year time and again, and they have learned that budget statements coming out of Washington are systematically not credible.

How the budget gap is closed is perhaps equally important as the pace that it is closed. The target set by Senators Nunn and Dominici of $2.75 of spending reduction for every $1.00 of tax hikes is a good one since much of the deficit increase has come from spending increases rather than from tax reductions in the past. The 2-to-1 target attributed to OMB Director Panetta would be quite satisfactory as well. But in principle, my own sense is that the better solution is to bend the spending line down towards the revenue line, rather than the other way around.

Process Reform:

The process by which we make budget decisions is clearly imperfect and could be improved. An item veto would be a plus. A clearer distinction between government "investment" and government "consumption" would be useful. Creative accounting and budget gimmicks are to be avoided. But in the current circumstance, the attention needs to be kept on making the hard choices, rather than on reforming the budget process.

V. REVENUES IN THE BUDGET

Despite a variety of important changes in the tax law in the 1980s, Federal tax receipts (in total) as a share of GDP have remained roughly constant. Income tax receipts have come down while payroll tax receipts have risen. Higher alcohol, tobacco, and energy taxes are appropriately under discussion. We must increase the rate at which we save and invest in order to achieve faster economic growth, and the tax code is an appropriate instrument for doing so. Longer term, we need to look to taxing consumption rather than income via either a value-added tax or consumed income tax. Whether the overall level of taxation in the economy ought to be increased or not is largely a philosophical matter. That issue aside our economy clearly would operate better in the coming years if we encourage savings and investment relative to consumption, increasing some taxes and decreasing others.

Savings and Investment Incentives:

The savings rate in the United States has fallen dramatically in the last quarter century, despite the fact that the demographics are pushing more people into those age groups in which they are routinely higher savers. The most important feature of the current tax changes being contemplated is that they encourage savings and investment relative to consumption. Reinstating the investment tax credit would be an effective direct incentive to the business sector to increase investment assisting in both productivity growth and job creation in the long run. The ITC would have some immediate impact in a counter cyclical stimulus sense. A capital gains tax cut as discussed during the campaign would also be a plus. More important, capital gains should be indexed to inflation are most other features of the tax code. Making permanent the research and development tax credit is also a plus, and liberalizing the individual retirement account rules to provide a further inducement to individuals to increase their savings rate also makes sense.

Twisting The Tax Code:

The basic incentives in the U.S. tax code are now perverse and should be changed. We need to encourage income and discourage consumption—not the other way around. While I am under no misconceptions about what might be practical for the new Administration in the next week, the desirability of this change in the long run should not be lost sight of.

Substituting a value-added tax for the income tax would be revolutionary and positive. VAT would be consistent with the tax codes around the world. VAT is regressive, but that regressivity could easily be offset with the current income tax code. The new VAT could be started at a nominal level so that the transition is easy, then phased up over time as the income tax is phased down with the two changes tied together in the law. The states have no proper claim that "sales taxes" are exclusive by their province. An explicit VAT line on every cash register receipt has the distinct advantage of making at least this one cost of government visible to the public.

A "consumed income" tax would have the same general objective. That is—to tax the share of income which is consumed, rather than taxing all income. While such a structure is inherently regressive, that regressivity could be offset by an appropriate structuring of the tax rates and brackets.

Income Tax Changes:

It seems clear that income taxes on high income individuals are going to be increased and that the middle-income tax cuts promised during the campaign will be a victim of the budget realities. With the various changes in income tax

rates since 1981 (both down and up) and with the persistent increase in the importance of payroll taxes as an overall revenue source, some consideration of the overall incidence of individual taxes is understandable. It is proper that the new Administration has advertised this as a matter of tax fairness—which is in the eye of the beholder—rather than of economics.

Alcohol, Tobacco, and Energy Taxes:

Given the new Administration's concern about health, it is understandable that higher alcohol and tobacco taxes are under consideration. The public generally seems to support these as sources of additional revenue.

A broad energy or BTU tax could raise significant amounts of money without targeting a single fuel (like the gasoline tax). It is perhaps ironic that 1993 is the twentieth anniversary of the first OPEC oil embargo, yet we still do not have what most would consider a comprehensive energy policy. The natural ally of higher energy taxes is environmental improvement.

VI. FEDERAL SPENDING

Federal spending rising at a rate that exceeds our overall economic growth rate year-after-year for the past quarter century has gotten us into the current budget dilemma. Ongoing deficits have pushed net interest expenses to new heights. All spending in the budget is not equal in its impact on the economy, and during the last generation government spending has been increasingly what could be called consumption rather than public investment. A new focus on investment—infrastructure, education, Headstart, and similar programs —would pay enormous long-run benefits. But what is really needed is a major retrenchment in transfer and entitlements payments—payments to individuals which are now well over one-half of the Federal budget. The current path is unsustainable.

All Spending Is Not Equal:

Blind allegiance to the size of the Federal deficit is inappropriate. Indeed spending in the Federal budget has changed dramatically during the past generation, with large increases in what is properly described as government consumption, with cutbacks in government investment—those programs which increment our long-run growth rate. But independent of where the cuts come, government spending cannot continue to rise dramatically faster than overall income. Perhaps more than any other single item, the public's measure of the new Administration's success at getting our economy back on track will be whether or not a credible budget plan is presented which reduces the outsized increases in spending.

Net Interest In The Budget:

Net interest in the budget—those interest expenses on our accumulated Federal debt—has increased from 9% of GDP in 1980 to 14% in 1993. This item is utterly non-discretionary. This increase has occurred at the same time that the 30-year Treasury Bond rate has fallen from 14% to 7%, with the 13-week Treasury Bill rate falling from 14% to 3%. The change by the Treasury to shorten maturity instruments sold to finance our ongoing deficits, thereby reducing interest expenses since the yield curve is positively sloped, is a small item not a large item when considering budget matters.

Infrastructure and Other Investment:

Infrastructure investment has fallen from just over 2% of GDP a quarter century ago, to just over 1% at present. There is significant unemployment in the construction trades, underutilized capacity in the industries serving that

sector, and infrastructure which needs repair. There is a natural match here, an opportunity for a quick lift to employment and incomes. Infrastructure investment is an obvious counter-cyclical measure.

Our education system, at least K-12, has failed us in the last generation as well. Our facilities there in many cases need upgrading, but most of what needs to be done in education likely can be accomplished without increased Federal outlays.

There are a variety of other Federal programs such as Headstart and assistance in drug abuse prevention and rehabilitation which are of the investment sort as well. The mind set needs to be on preparing people for economically productive lives in the future.

Payments To Individuals:

Payments to individuals have overwhelmed the rest of the Federal budget in the last generation, rising from 26% of the budget in 1960 to 54% of the budget in 1993. Combined with 14% of the budget in net interest and some level below which spending on national defense can not fall—for national security needs—much of Washington's discretion in the budget is gone.

From 1970 to 1993, these payments to individuals rose at a compound annual growth rate in real terms of 5.9%. From 1990 to 1993 that growth rate was 7.6%. Program after program has been established, all well meaning and with many beneficiaries. Most have been indexed to inflation and with the ever growing increase in the size of the recipient population for many of these programs as a consequence of the aging of the population and our changing demographics, the prospect under unchanged policy is for more of the same. This cannot last. The Federal government cannot indemnify all Americans against all events present and future which are unpleasant. Yet that seems like what has happened in this area of the budget.

Social Security is but one example. Social Security spending has risen from roughly $31 billion in 1970 to $307 billion in 1993, a real compound annual growth rate of 4.9%. While a one-year COLA freeze has seemingly been ruled out according to the popular media in recent days, a stepping down of the escalator clause protection from 100% protection to 90% (or something less) could be an important small savings which would match the tone of shared sacrifice. If all programs are hit at least somewhat, then the debate would turn on fairness on the spending side of the budget just as that seems to be the thrust in terms of taxes.

It is striking to note that when Social Security was founded in 1934 life expectancies were 61 years, 4 years less than the standard retirement age of 65. Now, however, life expectancies are 75 and still climbing. So without fan-fair the governments contingent liability to providing entitlements payments support to this segment of the population has grown by 14 years in the last half century.

Other Programs:

Other programs show similar rapid growth rates. Housing assistance has grown at a 12% real compound annual growth rate since 1970. Food and nutrition assistance has grown nearly as fast—albeit some of that can be considered as government investment not consumption.

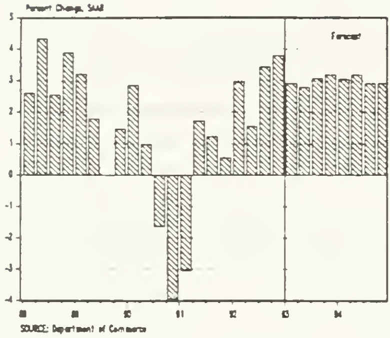
Health Care:

Health care (Medicare, Medicaid, other medical) has grown from roughly $12 billion in 1970 to almost $260 billion in 1993, a roughly 9% real compound annual growth rate. It is now roughly one-third of all payments to indi-

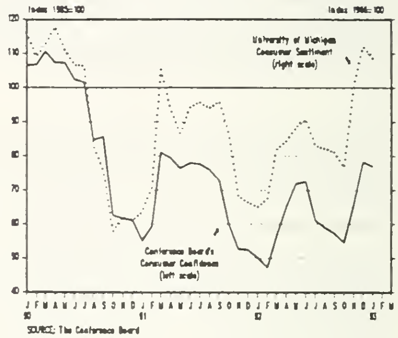
viduals and is growing rapidly. The new Administration's focus on health care is appropriate. Major economies will be needed if meaningful progress on slowing the increase in payments to individuals and accordingly reducing the size of the deficit is to be achieved.

Exhibit 1

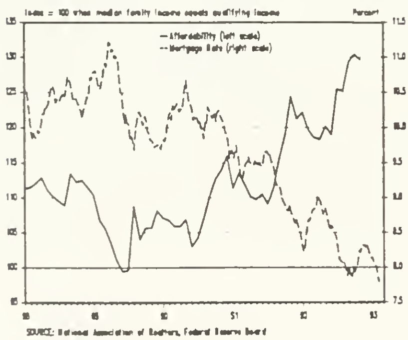
Economic Recovery
Real GDP Growth



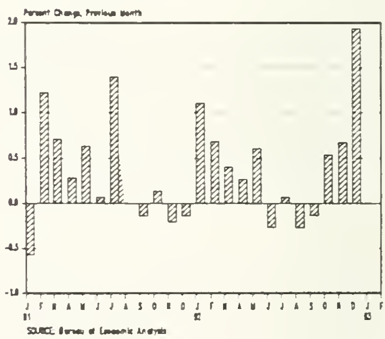
Consumer Confidence Steady
Two Measures of Consumer Confidence



Much Improved Affordability
Housing Affordability Index & Fixed Mortgage Rate



Leading Indicators Jump
Index of Leading Economic Indicators



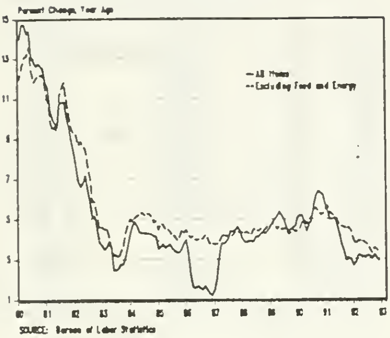
Merrill Lynch
Global Securities Research & Economics Group
Economics Department

Donald H. Straszheim
Chief Economist
212 449-0931

Exhibit 2

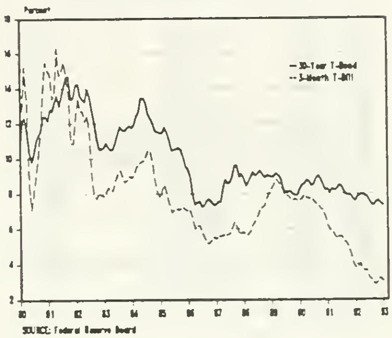
Inflation Abates

Consumer Price Index



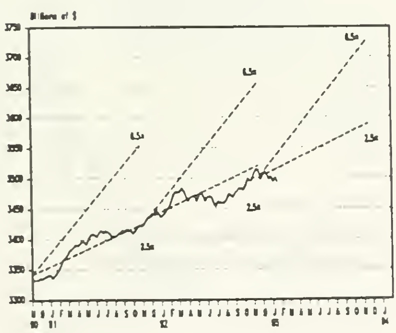
Short-Term & Long-Term Rates

3-Month Treasury Bill vs 30-Year T-Bond Yield



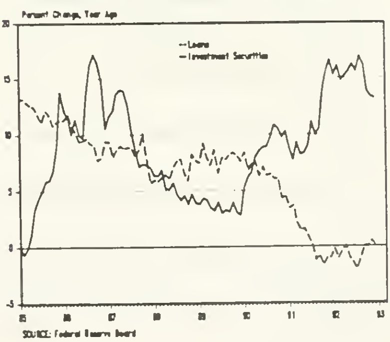
M-2 Below Target

M-2 Relative to Target



Bank Loans vs Bank Securities

Loans and Securities Held by Commercial Banks



Merrill Lynch
Global Securities Research & Economics Group
Economics Department

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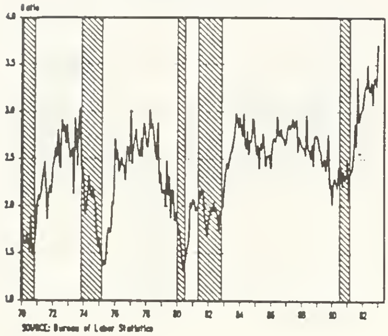
Chief Economist
212 449-0931

Exhibit 3

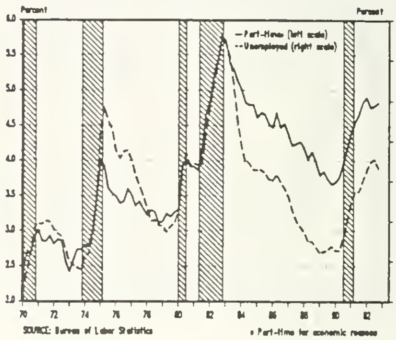
Our Troubled Unemployed

Permanent Job Losers/Those on Layoff



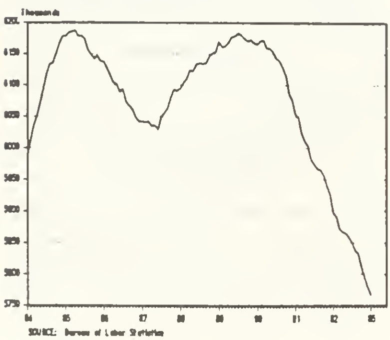
More Workers Can Only Find Part-time Work

Part-time Workers vs Unemployed as % of Labor Force



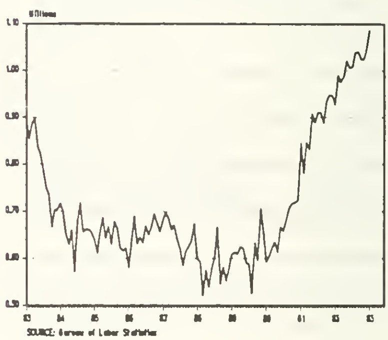
Industrial Companies Cut Overhead

White Collar Employment in Manufacturing



Unemployed Professionals

Unemployed Managers and Professionals



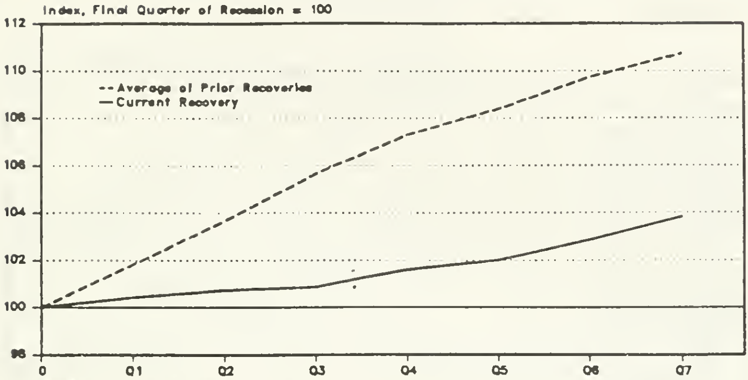
Merrill Lynch
Global Securities Research & Economics Group
Economics Department

Donald H. Straszheim
Chief Economist
212 449-0931

Exhibit 4

Weakest Recovery on Record

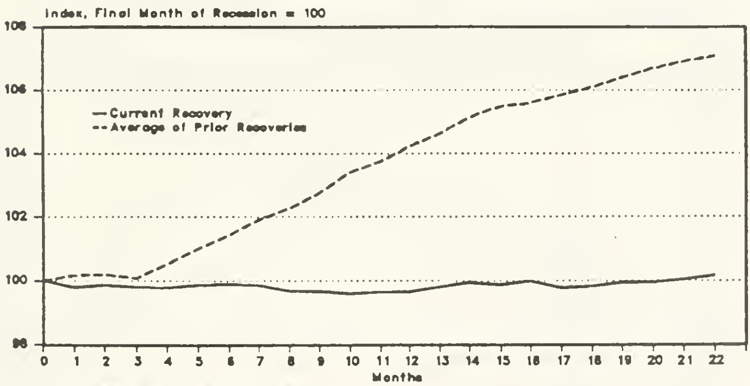
GDP: Current vs Previous Recoveries



SOURCE: Bureau of Economic Analysis

Employment Lags Prior Recoveries

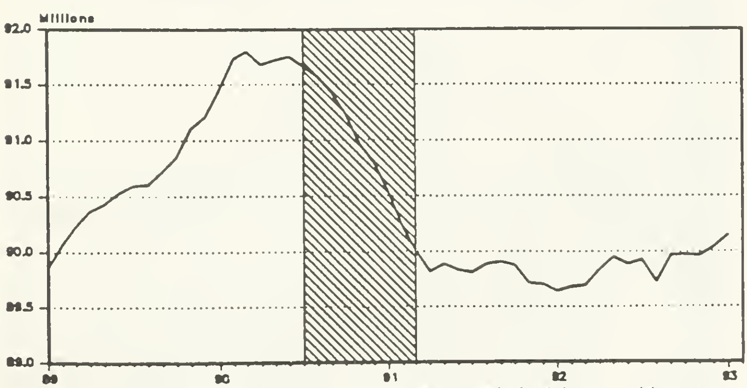
Private Employment: Current vs Previous Recoveries



SOURCE: Bureau of Labor Statistics

Private Employment Still Flat

Level of Private Nonfarm Employment*



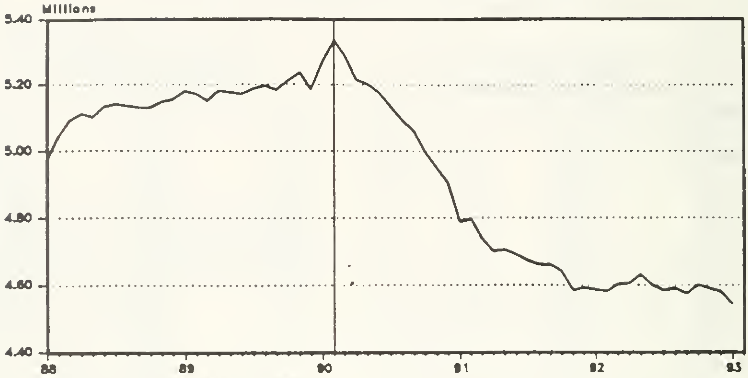
SOURCE: Bureau of Labor Statistics

* Excludes federally-funded summer jobs program

Exhibit 5

Construction - Hurt the Most

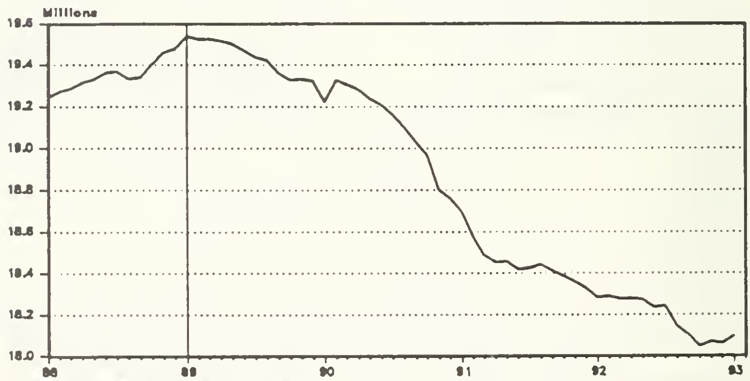
Construction Payroll Employment



SOURCE: Bureau of Labor Stastics

Manufacturing - Bottomed?

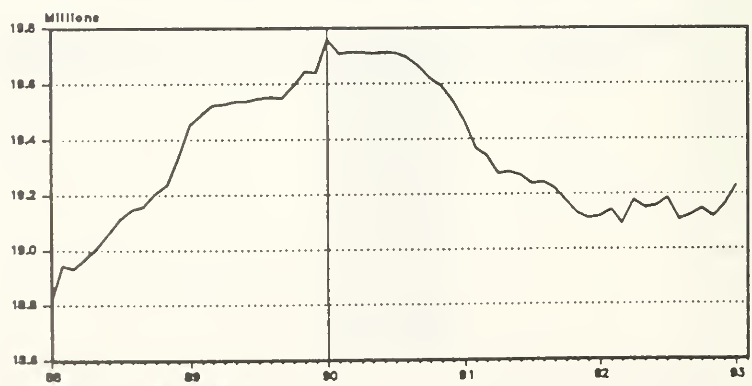
Manufacturing Payroll Employment



SOURCE: Bureau of Labor Stastics

Retail Trade

Retail Trade Payroll Employment

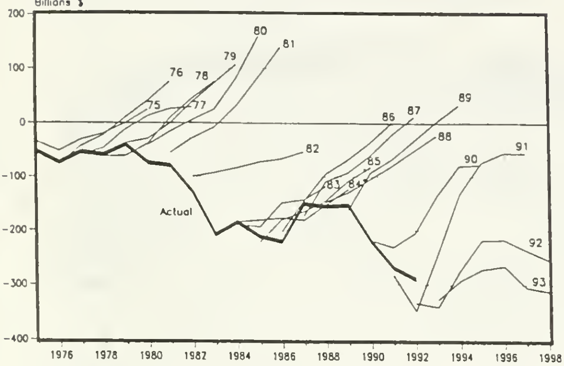


SOURCE: Bureau of Labor Stastics

Exhibit 6

'Budget Estimates of the Presidents

Surplus or Deficit



SOURCE: Office of Management & Budget.

How To Read This Chart

The bold line is the actual federal budget deficit from fiscal 1975 ($-60 billion) thru fiscal 1991 ($-269 billion).

The lighter lines are the budget estimates made by the various presidents over the years, the year noted being the year the budget estimate was submitted by the president.

Economic Assumptions of the Presidents Real GNP/GOP (% Change)
Calendar Years

Date & Source	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
2/75 Ford	-3.3	4.8	5.6	8.5	6.5	6.5																		
1/76 Ford		6.2	5.7	3.9	6.5	6.5	6.5																	
1/77 Ford			5.2	5.1	5.9	5.5	3.9	3.5																
1/78 Carter				4.7	4.8	4.8	5.0	4.7	4.2															
1/79 Carter					3.3	2.5	4.2	4.7	4.4	3.4														
1/80 Carter						-0.6	1.7	4.3	5.0	4.9	4.7													
1/81 Carter							0.9	3.5	3.5	3.7	3.7	3.7												
2/82 Reagan								0.2	5.2	5.0	4.7	4.4	4.3											
1/83 Reagan									1.4	3.9	4.0	4.0	4.0	4.0										
2/84 Reagan										5.3	4.1	4.0	4.0	4.0	3.9									
2/85 Reagan											3.9	4.0	4.0	4.0	3.9	3.6								
2/86 Reagan												3.4	4.0	4.0	3.9	3.6	3.8							
1/87 Reagan													3.1	3.5	3.6	3.6	3.5	3.4						
2/88 Reagan														2.9	3.1	3.5	3.4	3.3	3.2					
2/89 Bush															3.2	3.2	3.3	3.2	3.2	3.2				
2/90 Bush																2.4	3.2	3.2	3.1	3.0	3.0			
2/91 Bush																	0.9	3.6	3.4	3.2	3.0	3.0		
1/92 Bush*																		1.5	3.0	3.0	3.0	2.9	2.8	
1/93 Bush*																			3.0	2.9	2.5	2.5	2.5	2.5
Actual (GNP)	-1.3	4.9	4.7	5.3	2.5	-0.2	1.9	-2.6	3.8	6.8	3.4	2.7	3.4	4.5	2.5	1.0								
Actual (GDP)																0.6	-1.2	2.1						

* Real GDP

Source: Budget of the U S Government, various years

Note: Reading across any row shows the assumption of a particular president made on the specified date for the next six years.
Reading down any column shows the various growth assumptions for a particular year made over the space of six years.

Exhibit 7

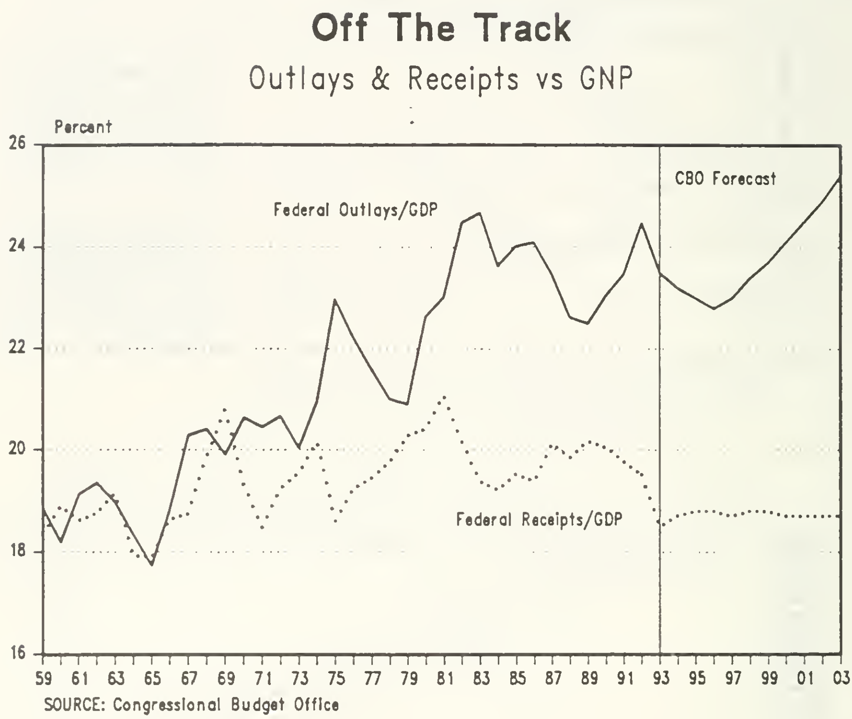
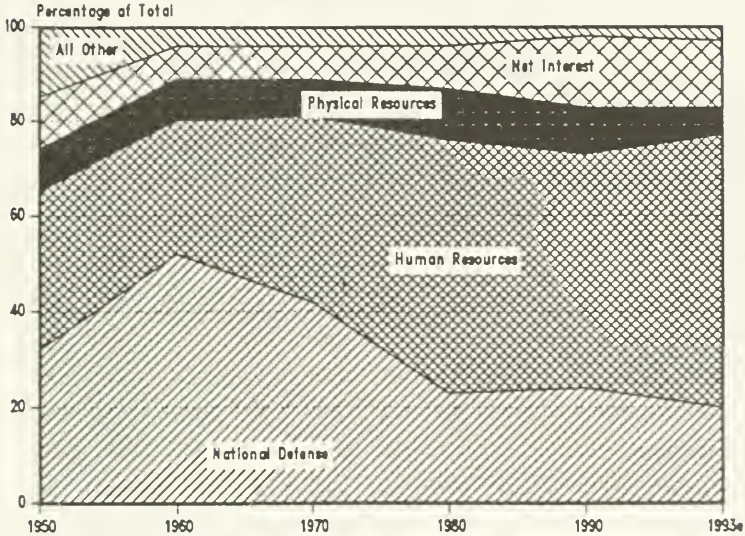

Off The Track
Outlays & Receipts vs GNP
Percent
26
24
22
20
18
16
CBO Forecast
Federal Outlays/GDP
Federal Receipts/GDP
59 61 63 65 67 69 71 73 75 77 79 81 83 85 87 89 91 93 95 97 99 01 03
SOURCE: Congressional Budget Office

Exhibit 8

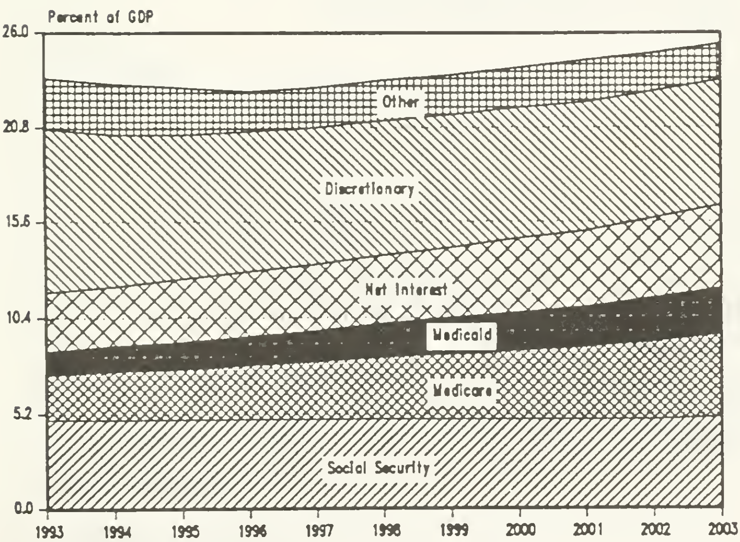
Budget Outlays by Function



SOURCE: Office of Management & Budget, 1/93

Federal Spending Prospects

CBO Estimates, As % of GDP



SOURCE: Congressional Budget Office

Exhibit 9

Payments to Individuals, $ Billions

	1960	1970	1980	1990	1993e	Nominal CAGR 1970-93	Real CAGR 1970-93	Nominal CAGR 1990-93	Real CAGR 1990-93
Social Security & R.R.	11.7	30.7	120.3	250.5	306.5	10.5	4.9	7.0	4.0
Fed Employee Retire	3.7	8.7	34.7	64.1	74.6	9.8	4.2	5.2	2.2
Unemployment Assistance	2.8	3.1	16.9	17.4	33.9	11.0	5.4	24.9	21.9
Medicare	1.1	6.8	34.0	117.4	155.0	14.6	9.0	9.7	6.7
Medicaid	–	2.7	14.0	41.1	80.5	15.9	10.3	25.1	22.1
Other Medical	–	2.5	9.1	15.7	21.7	9.9	4.3	11.4	8.4
Student Assistance	0.4	1.5	7.5	11.3	14.3	10.3	4.7	8.2	5.2
Housing Assistance	0.1	0.5	5.4	15.9	21.0	17.6	12.0	9.7	6.7
Food/Nutrition Assistance	0.2	1.0	13.9	23.9	37.6	17.1	11.5	16.3	13.0
Public Assistance	3.3	6.4	19.4	33.3	51.5	9.5	3.9	15.6	12.6
Other Payments	0.7	0.9	3.4	3.4	4.6	7.4	1.8	10.6	7.6
Total, $ billions	24.2	64.8	278.5	584.1	789.5	11.5	5.9	10.6	7.6
% of Total Outlays	26%	33%	47%	47%	54%				

Source: Office of Management and Budget, 1/93

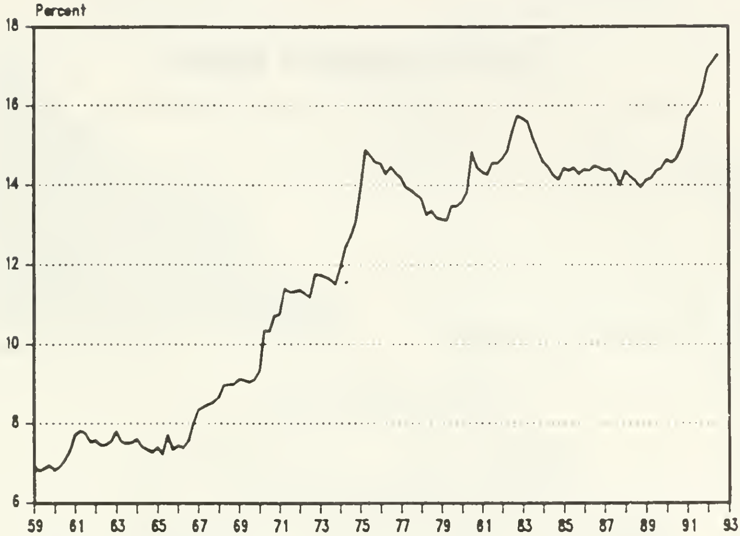
	1970	1990	1993	CAGR 1970-93	CAGR 1990-93
Nominal GDP, $ billions	1010.7	5522.2	6271.3	8.3	4.3
Real GDP, $ billions	2873.9	4877.5	5070.6	2.5	1.3
Implicit Price Deflator, 1987 =100.0	35.2	113.2	123.7	5.6	3.0

Note: CAGR = Compound Annual Growth Rate
Nominal values deflated by implicit GDP price deflator

Exhibit

More Transfer Payment Income

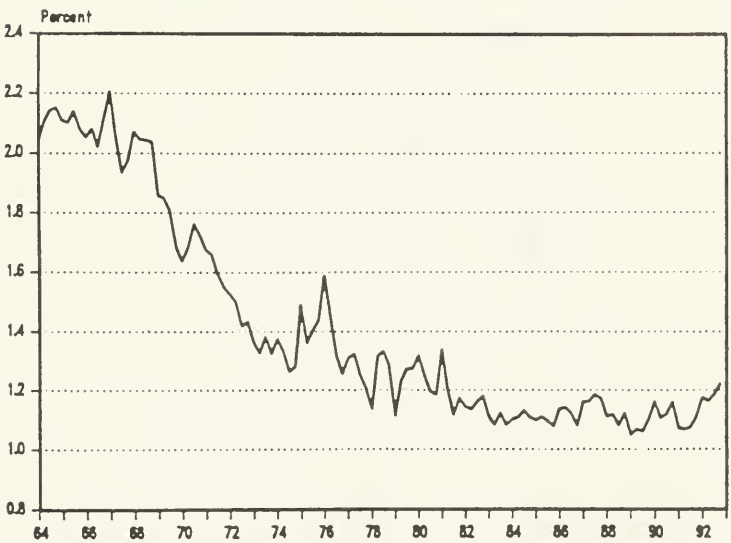
Transfer Payments as a % of Personal Income



SOURCE: Department of Commerce

Our Neglected Infrastructure

Capital Outlays for Public Works as a Percent of GDP

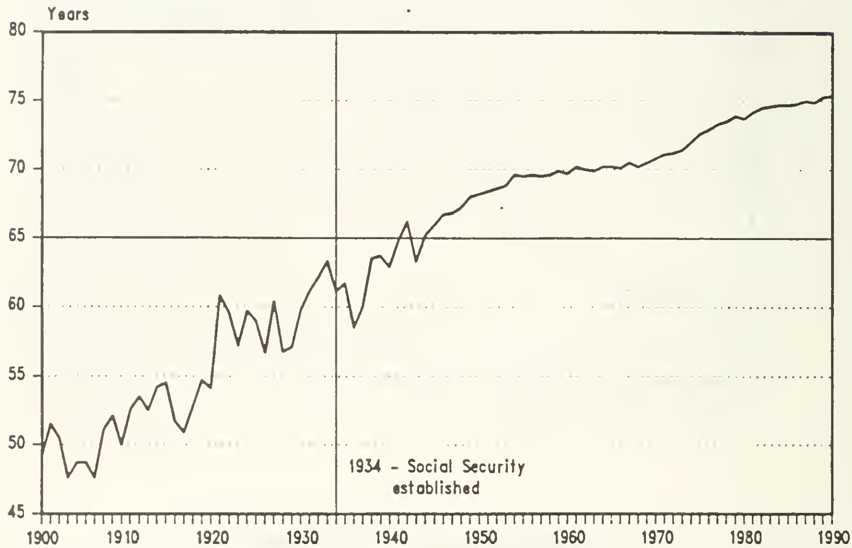


SOURCE: Department of Commerce

Exhibit 11

The Retirement Burden

Life Expectancy at Birth versus Retirement at 65

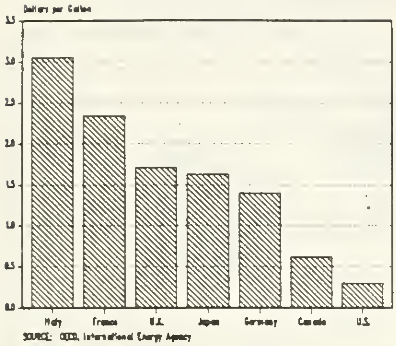


SOURCE: Bureau of Census

Exhibit 12

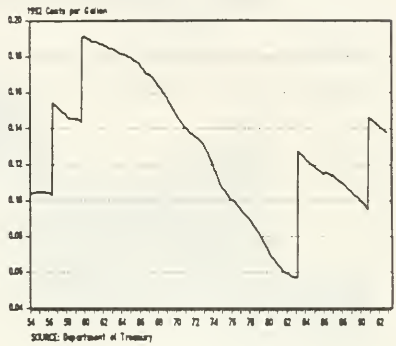
Global Gasoline Taxes

International Comparisons



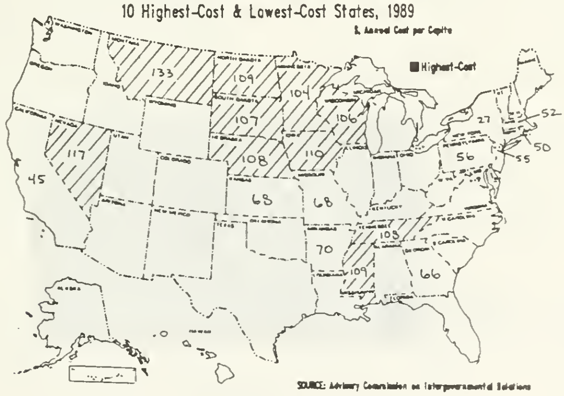
Real Gasoline Tax

Inflation-Adjusted Federal Excise Tax on Gasoline



Per Capita Gasoline Tax Costs

10 Highest-Cost & Lowest-Cost States, 1989



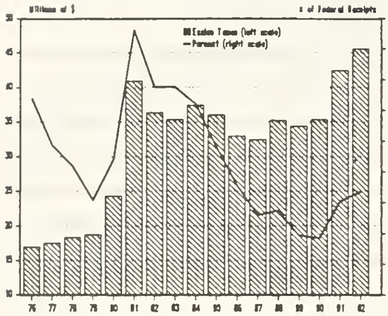
International Comparisons - Dec 1992

	Price ($ per Gallon)	Gasoline Taxes ($ per Gallon)	Tax as Percent of Price
Japan	3.79	1.77	47%
Germany	3.19	2.36	74%
U.K.	3.01	2.08	69%
France	3.66	2.84	78%
Canada	1.64	0.78	48%
U.S.	1.12	0.33	29%

Exhibit 13

Excise Tax Revenue

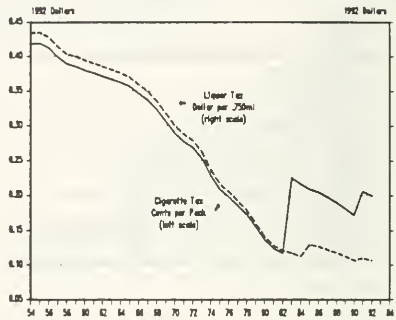
Excise Taxes



SOURCE: Office of Management & Budget

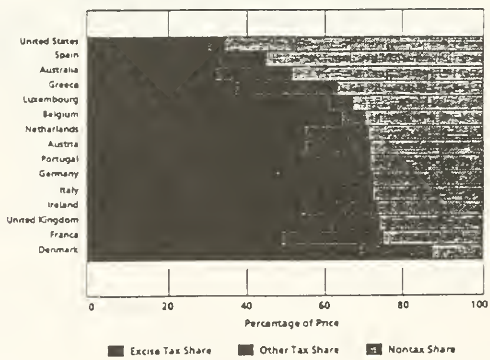
Real Sin Taxes

Real Federal Excise Taxes: Cigarettes and Liquor



SOURCE: Congressional Budget Office

Share of Sales Taxes in Cigarette Prices in OECD Countries, 1987



SOURCES. Organization for Economic Cooperation and Development, *Taxing Consumption* (Paris OECD, 1988), and Congressional Budget Office calculations based on data from The Tobacco Institute *The Tax Burden on Tobacco*, vol. 22 (1987), and Department of Agriculture, Economic Research Service

NOTE The U.S. tax shares are based on Congressional Budget Office calculations from Tobacco Institute and USDA data on taxes and prices

THE 1993 ECONOMIC REPORT OF THE PRESIDENT: THE PRESIDENT'S ECONOMIC PLAN

MONDAY, FEBRUARY 22, 1993

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The Committee met, pursuant to notice, at 10:00 a.m., in room 2172, Rayburn House Office Building, the Honorable David R. Obey (Chairman of the Committee) presiding.

Present: Representatives Obey, Hamilton and Cox; and Senators Bingaman, Robb, Dorgan, Craig and Bennett.

Also present: Stephen A. Quick, Executive Director; William Buechner, Lee Price, and Ed Hudgins, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

REPRESENTATIVE OBEY. Good morning. This morning the Joint Economic Committee welcomes Dr. Laura D'Andrea Tyson, Chair of the President's Council of Economic Advisers for her first appearance before the Joint Economic Committee.

The Council of Economic Advisers and the Joint Economic Committee were created by the Employment Act of 1946, with the responsibility to present the best advice possible on economic policy to our respective branches of government.

I am particularly glad to see that the President's top economist has gained a substantial reputation as a microeconomist and a real-world economist. In economics, as in politics, we have to see the big picture, but we must also work our way through the details. We can map out how things should work in theory, but we also need to know what will work in reality. Dr. Tyson is skilled at getting people to look at the economy through the prism of real work experiences, and I think that will be an enormous strength for the new administration.

Dr. Tyson is the Administration's chief economist, and in that capacity, is here to explain to the Congress and to the American people the economic basis for the decisions made in the President's plan presented to us last week.

Between World War II and the early 1970s, the economy was on a path that provided increasing job opportunities and family incomes. The poverty rate was declining, the gap between the richest and the poorest was closing. At the same time, we were paying off the enormous debts that were run up during World War II and the federal debt as a percentage of GDP was declining. We felt good about our economic future, and we wanted our children to do better than we had done.

Around 1973, growth started to slow, and with it, our ability to raise incomes and to pay down our debt. By the end of the 1970s, Americans had grown concerned about these negative developments, and wanted to do something to improve the outlook. They were told it would be easy, that you could cut taxes, especially at the top, and the benefits would trickle down.

Things did get better if you were extremely well-educated or extremely well-connected. The rich did get richer and the gap between the rich and everyone else widened for the first time in decades.

I cannot repeat often enough that if you take the income gains of the 1980s and total them up, you will see that the richest 1 percent—those with incomes averaging roughly $600,000—experienced more income gains than 90 percent of all Americans combined.

For the average worker in the 1980s, good jobs became harder to come by. Stagnant incomes forced more families to send two people out to be breadwinners, and the burden of debt-government debt, private-sector debt, and household debt-increased dramatically.

Over the last few years, the economy's engines started to shut down altogether. Incomes and employment actually declined. We had a serious recession and we now are in a technical recovery that is not restoring jobs. The deficit is skyrocketing. This country is in serious economic trouble and we cannot continue on this path.

The President's plan represents a major change in economic policy and in budget practice. Not all of us are going to agree with every individual item, and it is Congress's responsibility to review the proposal carefully, but as a whole, it is an honest and fair budget. The primary burden will fall on those who can bear it most.

The wealthiest Americans will be asked to give something back for the gains they enjoy. Middle-income Americans will not pay higher income taxes, and will be asked to contribute a modest amount each month, depending upon how much energy they consume. And we will finally end a distinction between us and most other industrialized countries, a distinction that has not made us proud. In this country, there are still many Americans who work full time and still must raise their children in poverty, even though they work full time. One of the best things about this plan is that it rewards hard work by changing the Earned Income Tax Credit to ensure that a parent who plays by the rules—works 40 hours a week and has kids at home—will no longer

live in poverty. That is the least our system ought to be able to do for hard-working Americans.

The real issue for any income group is not whether this package will cost them something, but whether this package will cost them more than continuing the status quo, that to me is the real issue. Without major change, it will be harder to find a decent job; harder for people to find an affordable home; harder for them to send their kids to college. Most of all, if we do nothing, it will be harder for each of us to look into the eyes of our children and our grandchildren and tell them we have met our responsibilities to their future.

Before we begin, Congressman Ramstad, who was not able to attend the hearing, has requested that his statement be entered into the record.

[The written opening statement of Representative Ramstad starts on p. 127 of the Submissions for the Record:]

Doctor Tyson, welcome, and please proceed with your statement. You can insert it in the record and summarize any way you choose.

STATEMENT OF THE HONORABLE LAURA D'ANDREA TYSON, CHAIR, COUNCIL OF ECONOMIC ADVISERS

DR. TYSON. Thank you very much. It is a real honor to be here before the Committee.

This is my first official testimony before a committee, and I think it is appropriate that it be before the Joint Economic Committee. We have a long history of the Council of Economic Advisors working with the Joint Economic Committee, and I look forward to that over the next several years. This is an honor, and I hope I can explain to you the President's program and the economic basis for the President's program.

As you said in your opening statement, Congressman Obey, the three-part plan that the President has put together is really designed to reverse some of the long-run trends that we have been living with that really suggest that we can no longer take for granted prosperity for future generations of Americans.

The trends that are most disturbing are stagnant real family incomes, despite the fact that we have an increasing number of two-earner income families; that an increasing number of fully employed Americans cannot earn enough to bring a family of four to the poverty level; that we have an increasing incidence of poverty among children and that we have the highest incidence of poverty among children of the advanced industrial nations; and that we have growing deficits and a growing debt burden.

Normally, when an economy recovers, one expects to see the deficit as a percentage of GDP decline. One hopes to see a decline in the debt/GDP ratio. In fact, if you look out over this decade and you assume economic recovery, you still see the deficit/GDP ratio rising and the debt/GDP ratio rising.

Besides these long-run trends, we also have the short-run problem of a relatively weak economic recovery following a prolonged period of slow economic growth. So, if you ask the average American, is the recession over, they don't pay attention to the fact that the National Bureau of Economic Research says the recession was over in March 1991. They feel, correctly, given their job and income prospects, that the recession is still in force. So we have to deal simultaneously with the short-run problem of speeding up economic recovery and getting us back to economic capacity more quickly, and the long-run problem of increasing the rate of productive capacity of the economy, which will allow us to generate higher real income growth for our families. At the same time, we have to address some of the inequities in the system to deal with the problems of workers working full-time and not being able to reach the poverty level, or poverty among children.

So we have a series of short and long-run problems that we are trying to address simultaneously in an ambitious package consisting of three parts: An economic stimulus package designed to deal with the recovery, an investment package designed to deal with what I will refer to as an "investment deficit"— an underinvestment by the private and public sectors in the foundations of our future economic growth—and a deficit-reduction package.

Let me talk about each of the three parts and give the economic thinking behind them.

On the issue of economic stimulus, we look at the recovery to date and we can see several features of the recovery. Although the rate of growth of GDP has accelerated somewhat in the past two quarters, it is still below rates of growth that one might see in normal economic recovery. Even more dramatically, it has largely been a jobless recovery. The unemployment rate is still higher than it was at the bottom of the recession.

We have calculated and the President has reported, compared to the average of previous recoveries, we are 3 million jobs short of where we would be if we had a normal economic recovery.

In 1992, the fraction of unemployed workers who do not expect to be recalled to their jobs is at the highest level on record. People view themselves as permanently unemployed, which is part of the reason people don't see the recession as over.

So for these reasons, we believe that the economy needs some economic stimulus to help speed up the recovery and generate some jobs. That is the first part of our program.

The program is a balanced program of expenditure increases and tax cuts essentially approximating $30 billion in total. The total spending increases are within the bounds of the feasible, within the bounds allowed by the 1990 budget agreement.

On the spending side of the stimulus, we have tried to take programs that we believe need to be increased over the next four years anyway as part of our investment package and do some spending up front to create

some jobs. We can discuss the particular components of the stimulus spending package, but if you look at it, I would argue that we have chosen a series of public investment items—infrastructure, youth employment, Head Start and energy conservation—a number of areas we want to move on for public investment purposes anyway. We believe by moving on them early we can help generate additional jobs for the private sector.

On the tax incentive side of the stimulus package, we are doing things that we want to do for the long-run anyway. We want to get the private investment rate up. We can do that by using targeted tax incentives so that our stimulus program includes a temporary incremental investment tax credit for large companies and a flat investment tax schedule for small companies. In addition, we will be adding capital gains tax relief, which will encourage the formation of new small businesses. Overall, we estimate that the stimulus package we are proposing, if enacted speedily, will generate about 500,000 additional jobs above and beyond what the recovery itself will generate over the next two years.

We are undercapacity by approximately 4 percentage points. We are moving towards our capacity at a relatively slow rate compared to past economic recoveries. The stimulus program should accelerate the rate at which we get that up to our capacity, and that is the whole motivation of stimulus. Again, we have chosen a package that we believe can be also viewed as a downpayment on our long-run investment package.

The investment package is meant to take our capacity over time, our long-run growth capabilities, and increase them. We begin with the notion that our long-run growth capability depends fundamentally on our productivity growth rate and what we can afford to pay ourselves as workers, which depends upon how productive we are; and how productive we are, depends upon how much we invest in ourselves.

We have looked at our investment rate, both investments by private businesses as a percentage of GDP and public investment by the public sector as a percentage of GDP. If you compare the United States to other advanced industrial companies, you can see that the United States suffers from a relative deficit on both scores. We underinvest relative to other advanced industrial countries in the private, and we underinvest in the public sector as well.

So the investment program is meant to target public and private investment, to increase spending on both accounts. That, in turn, will lead, we believe—and all economic studies confirm this—to higher rates of growth and productivity; and that, in turn, will lead to higher rates of growth in real family income over the long run.

We can talk about the specifics of the package in the question-and-answer period.

Let me say a couple of general things. The investment package consists of $160 billion over four years. About $100 billion of that is in

public spending initiatives, and about $60 billion is in a variety of tax incentives.

On the spending initiatives, we are looking at four general areas: infrastructure spending, which includes things like highways; but also information highways; defense conversion; and also environmental issues. So infrastructure broadly defined.

A second general component is lifelong learning activities. We believe very much that we need to invest in workers from Head Start through their job training career. Workers have to change what they do in this very competitive world. Workers cannot anticipate that they will hold the same job during their working lifetime. We need to provide training systems so that they can move from job to job effectively. We go from Head Start through worker assistance programs.

We also have in this component the lifelong learning component of the investment package, an important national service initiative that would try to help students choose a way to finance their college education and give something back directly to society in the form of service.

We have a third component that we call "rewarding work." A large component of that is the Earned Income Tax Credit. We certainly agree with the notion that a major shortcoming of our economy, as it functions, is that a much too large a number of fully employed American workers cannot bring a family of four above poverty. Our use of the Earned Income Tax Credit will change that.

Finally, we have one part of the investment program that is a health initiative's agenda. We consider the health problem confronting us as a long-run structural problem, which we are going to deal with through a proposal for a comprehensive health reform that will come later in the spring. Whatever happens in how we structure that long-run health reform package, there are some national health agenda issues that we must address immediately, including issues related to AIDS, and issues related to childhood immunization, issues related to drug and substance abuse. So we have put together a spending package in the investment package to try and deal with those.

On the tax incentive investment side, we are really suggesting a number of targeted tax incentives on investment, on the formation of new businesses, on research and equipment expenditure on enterprise zones. We are trying to use the tax system to encourage exactly the level of investment and the kind of investment that we think are very important to the long-run growth potential of the economy.

So it is very different in its conception from the approach of the 1980s, which was more to give energy tax relief and hope for investment. Our approach is to say, what can we use in the tax incentive structure that had target investments so that we will be sure that we get what we need, which is an increase in the investment rate.

From our investment package, it is a natural step to reduction, because the investment package, remember, is designed to increase public investment and private investment and get the long-run growth poten-

tial of the economy enhanced. The reason we care about deficit reduction is the same. We want to get the long-run growth potential of the economy enhanced, and we believe that the problems of deficit and debt that we face are essentially a constraint on our long-run growth capability. So it is important to emphasize that deficit reduction is a means to an end, not an end in itself.

We believe that we cannot achieve this growth rate in economic performance that we want to achieve with the deficit and debt constraints currently confronting us. We are looking without doing anything to a deficit/GDP ratio, which in the mid-1990s begins to increase despite the economic recovery. If we do nothing, the debt-to-GDP ratio will rise towards the end of the decade to upwards of 70 percent.

It is already the case this year that two out of every three dollars the government borrows goes to pay interest on past debt, so we are constrained in terms of our ability to spend revenues the government brings in on anything other than interest payments. That problem will continue if we don't get the deficit under control.

The way we believe deficit reduction will enhance investment is that as the government decreases its borrowing claims on capital markets, domestic and international, the rates at which private borrowers can borrow will become more attractive, and that will encourage more private investment. So the government will reduce its claim on investable resources, allowing those resources to be used increasingly by the private sector at more attractive rates.

When we dealt with the challenge of deficit reduction, one of the issues we had to confront was how big the deficit reduction effort should be over a certain time and what composition of expenditure cuts and revenue increases it should consist of. We were looking for a balanced approach, a large enough deficit-reduction package so that it would be credible to our citizens, to the capital markets. We were looking for a deficit-reduction package that would be big enough to effect the pool of investable resources and the terms at which private investors can borrow. We were looking for a deficit-reduction package with an appropriate balance between spending cuts and revenue increases.

We have come up with one that, as you know, in 1997, achieves a deficit reduction about $140 billion. It is a gradual program, I think, appropriately phased in, because you want to phase it in as the economy recovers so that you don't derail the economic recovery.

On the spending side, we have gone through a series of spending cuts that go across-the-board, from defense to nondefense to entitlement, to cuts in the interest burden that the government faces. So I think, if you look at our motivation in terms of what we were trying to cut—we were looking for cuts—our list of 150 cuts includes a number of things: programs we believe are no longer needed; programs where we believe that we are either eliminating unnecessary subsidies, or, in some cases, going to charge more appropriate fees for government services—programs we are trying to cut where we believe the result will be an increase in efficiency or the cost-effectiveness of government.

We are adjusting defense to deal with the change in priorities that we face as a Nation and we are trying, in general, to set a model from the top down. We have begun serious cuts in the White House staff. We are planning very serious cuts across the agencies of government. We are taking out various perks. We believe if we, as a government, set a model for how we can be more efficient and economize on costs and continue to provide services, that that will help the process of making cuts throughout the government.

On the issue of revenues, we have gone for a balanced revenue package that I would say has addressed some of the concerns that Congressman Obey mentioned about bringing a greater degree of progressivity back into our income tax system by changing the upper-income tax rate. We have proposed an increase in the corporate income tax rate, but if you look at the rate we have proposed it, we are still under the rates that are in operation in other advanced industrial countries. In addition, we are providing a series of offsetting tax incentives for the private sector as well.

In addition, we have proposed a broad-based energy tax that has a number of important economic features besides raising revenue. This tax will encourage energy conservation, discourage harmful emissions, and will reduce our dependence on oil imports. So it is a tax that has a number of positive features besides being one source of raising revenue.

We estimate that if we do all these things, we will bring the deficit/GDP down to half by 1997; down to a range of 2.4 percentage points. We will stabilize the debt/GDP ratio by 97, and that we will, along with our productivity-enhancing packages, increase our long-run growth potential.

In conclusion, I think this is a balanced package. I think it is a very serious package. If I put it all together, I guess I would say the linchpin of all three parts is the critical role of investment and our notion that we must, as a Nation, increase our private investment rate and our public investment rate.

We must not encourage deficit reduction at the expense of certain public investment. That is why we propose increases on spending on infrastructure, education, health, environment and technology. We believe that those public investments are important to our long-run productivity, just as private investments are.

If we get the increase in investment that this plan would encourage, then we believe we will be on the path again to increasing our long-run productivity growth rate, increasing our family income growth rate, and restoring some fiscal sanity and fiscal responsibility to our federal accounts.

Let me stop there. We can handle the details in questions.

[The prepared statement of The Honorable Dr. Tyson starts on p. 128 of the Submissions for the Record:]

Representative Obey. Thank you.

I just have one question before I ask other Members of the Committee for their questions. You indicated—and I think this needs to be emphasized—that the stimulus package that you are proposing for this year will not result in one dime of total spending above the amount contemplated in the 1990 budget agreement?

Dr. Tyson. That is right. We structured this stimulus package within the discretionary spending limits.

Representative Obey. Second, for those who are concerned about the fact that you are picking on the rich, I saw a number of people on a talk show on Sunday who were concerned about the crushing of the work ethic among the very wealthy if you increase their taxes, stipulating that no working-age American will have an income tax increase unless they are in the top 2 percent of earners in this country.

Putting that in context, isn't it true that from 1983 through 1989 alone, the share of this Nation's wealth that went to the top 1 percent increased from 31 to 37 percent? Isn't it also true that from 1979 to 1990, real income for the top 1 percent went up by more than 77 percent, whereas their effective tax rate went down by almost 20 percent?

Dr. Tyson. I think that we are indeed in the process of trying to restore some progressivity into the system to reverse some of the trends that we observed in the 1980s. Part of the motivation here is to do that.

I think that our view is, again, if you look at growth in median real family incomes—notice that I said median real family incomes—were unchanged since 1979 which is, to me, a disturbing indicator that a nation as rich as ours can generate no growth in real median family income for such a long time. If you look behind that average, you will see that there was significant growth in the highest 20 percent, and if you then break that down, you will see even more rapid growth in the upper 10 or upper 2 percent. There was stagnation in the middle, and there was a decline at the bottom.

So we are confronting a long time in which the trends were moving to spread apart the distribution, and we want to restore some progressivity into the tax burden to undo part of that. It will be a restoration of part of that progressivity.

Representative Obey. Congressman Hamilton, please proceed.

Representative Hamilton. Thank you, Mr. Chairman. I am very pleased that you are going to be leading the Joint Economic Committee this Congress, and I commend you for the leadership you have given in these areas in the past.

Dr. Tyson, we are pleased to welcome you to the Joint Economic Committee, and we look forward to working with you over the next few years. I have questions, too, about the President's program.

First, I do want to say that I think the President is seeking to reverse some very disturbing economic trends, which you have pointed out in your testimony. He has done that with considerable courage and has a program I think that moves very much in the right direction, and I commend you and the President for that.

Now, I don't know if you saw the column in the *Wall Street Journal* this morning. I have an advantage over you. I have read it, and you may not have read it yet. On the front page in the "Outlook" column, it says that the Achilles heel of his economic plan, and I am quoting now, "Is its reliance on tax increases rather than spending cuts to reduce the deficit." I am quoting two or three sentences here, not necessarily successive:

> But only the most generous sort of accounting combined with an immodest puff of blue smoke enables him to make such a claim.

I continue to quote:

> Among the least questionable items counted as spending cuts in the plan, $21 billion raised over the next four years by taxing social security benefits, $11 billion saved by shifting from long-term to short-term debt, $24 billion in reduced debt service costs, at least $6 billion in new users' fees and more than $80 billion in four years that were required if not actually specified under the 1990 budget agreement, take those away and the net spending cuts virtually disappear.

What I would like you to do is to comment on this battle that is developing over the proposed tax increases and the proposed spending cuts, if you would. It seems to me that the focal point of the debate on the President's program is, at least initially on this, that it is very important to have your point of view, with regard to these criticisms, with respect to too many tax increases, not enough spending reductions.

Dr. Tyson. Okay.

The first thing I would say is that I think that if you look through this package, unlike previous attempts to address the deficit, this lies out in very specific minute detail a spending program to be cut and exactly the amounts that will be cut year by year. So I think that actually we have been very specific and instead of talking about freezes or caps without specificity, we have actually said that these are the programs we want to cut.

We have also taken the position that we are willing to entertain any serious suggestion for further cuts. We are committed to the notion of overall deficit reduction of the magnitude that we have proposed, because we believe it is of essential significance to the long-run health of the economy. We do not want to deviate from the size of deficit reduction. We are encouraging people to make proposals for additional spending cuts.

These were the spending cuts that we felt met a variety of criteria. They were cuts in programs that we felt were no longer useful, or they were cuts to make the government more efficient or they were cuts to increase user fees where the fees represented an unnecessary subsidy to a particular activity. We were looking not just for something to cut, but something to cut that made sense to cut.

One cannot cut interest payments on the debt. I do not understand the notion that if we bring our deficit down and slow the rate of growth of

our debt and bring long-term interest rates down—and they have already come down significantly just in anticipation of what we propose to do—interest payments on the debt will come down. Most Americans, I think, correctly, think of that as a major saving, a major reduction in government spending.

We are currently spending $200 billion to service the debt. If we can save $25 billion of government spending on servicing the debt, I think that is a major spending reduction. I don't understand the *Wall Street Journal* position on that. I don't understand the $16 billion in user fees. That is what we should be doing.

We are providing services. Many of these are highly subsidized. These services will continue to be provided, but we are asking for a fee for them. I think we have a balanced package.

I don't see how one can look at the size of the deficit problem we confront and at the items on the spending side of the table and think it is realistic to make the case that one can get the magnitude of deficit reduction that we have proposed without some revenue increases. It is simply not possible.

As a percentage of GDP, social security has not been increasing. We are handling medical care. We are doing some Medicare cuts to providers in this package, but a lot of the out-year increase in the deficit and debt on medical care is going to be handled as a systemic reform later.

Having taken that off the table for systemic reform, I think we have done a very serious job of cutting what we believe can be cut, but we invite further suggestions.

Representative Hamilton. I guess my time has expired.

Thank you, Mr. Chairman.

Representative Obey. Congressman Cox.

Representative Cox. I would like to follow up on Mr. Hamilton's question on social security, because I note that in your testimony that you have included, in your own words, higher taxation of social security benefits as a spending cut. Why do you do that?

Dr. Tyson. I think that is the one of all the ones that are listed that I think one could make a case for on either side.

Representative Cox. I would like to interject. This is not just a matter of semantics.

Dr. Tyson. No, it is not just semantics.

Representative Cox. The fact is that the President is abroad in the land saying that the ratio is one-to-one of spending cuts to tax cuts. Our own numbers show that the tax increases are really 72 percent of all the deficit reduction. Seventy-two percent of all the deficit reduction is coming from tax increases. It makes a big difference if you take a tax increase and put it on the spending cut side. If you are increasing taxes on social security recipients, call it a tax hike.

Dr. Tyson. It is not a semantics argument. It is a conceptual argument. Social security benefits are a benefit provided by the govern-

ment. One can reduce the benefit. That is a cut in government spending. We reduce the benefit through collection by the IRS, so you can count that as a tax increase, if you want. The effect is to reduce the benefit.

Representative Cox. Is that the argument? If we raise taxes on all members of the military in America, if we raise taxes on all federal workers through the income tax system, that is a spending cut?

Dr. Tyson. No, no, no. The reason that this is different is that we are providing a benefit to the elderly in the form of a social security payment.

Representative Cox. Some people think that what they are getting is their retirement contributions-

Dr. Tyson. We know that they are getting $3 or $4 more than their retirement contributions. That isn't right. You are giving someone a benefit. If you reduce the benefit, that can be viewed as a cut in government spending. We might ask the social security recipients to send back $50 of their benefit. Then it would show up as a cut in government spending.

Representative Cox. So, if we raise taxes on Dr. Tyson, who is a government employee and 100 percent of whose income comes from the government, we are in fact reducing government spending because the government sends money out and then collects some of it back, and that way we spend less money?

Dr. Tyson. That is not right. I am getting a payment by the government for a service. You may not like my service, but nonetheless I am being paid for a service.

Representative Cox. Social security recipients are getting their benefits back as a consequence of paying into the system over their lifetimes on a contractual basis.

Dr. Tyson. They are getting more than they put in over their lifetimes by a significant amount.

Representative Cox. Except that they may have contributed in the '30s, '40s and '50s. The government has had it all those years. They ought to get more back than they put in, dollar for dollar.

Dr. Tyson. The additional amount is a benefit. It is a notion of what size benefits the government should be providing. That is an issue of what size spending the government should be providing.

Representative Cox. I would like to ask one additional question and then pass on my time, because this gets to the integrity of the numbers that the Administration is using.

I think the example, which in your testimony is stated to be a tax increase, being classified as a spending cut is why the *Wall Street Journal* is saying what it is saying, and pointing to that specific example. You also mention a 25 percent cut in White House staff spending, yet we know for a fact that the $10 million cut you claim will result is wrong. It is just not true. It is not a $10 million cut. We had this from

Leon Panetta who told us it is a $9 million cut, and not this year, but later.

We also know that this is not a 25 percent cut from the Treasury reports. Treasury gives the amount of spending for the Executive Office of the President as $190 million for fiscal year 1992. A 25 percent cut would be $47 million. If you are cutting $9 million and claiming this as a 25 percent cut, that assumes the White House budget is only $36 million. You have engaged in all sorts of gimmickry to come up with a $36 million tiny denominator. Why do you keep using this figure of a 25 percent cut in the White House when we know it hasn't happened?

Dr. Tyson. The 25 percent cut in the White House is a staff cut in the White House. I can only attest to my personal involvement in that. The staff of the CEA has in fact been cut 25 percent. Two perks of the CEA have been curtailed. The 25 percent cut is a staff cut, and those numbers are real. Those numbers are real.

Representative Cox. Do you know whether it is true that there are more lawyers added to the White House staff?

Dr. Tyson. I have no idea what the composition of the White House staff is.

Representative Cox. Have there been more than 50 new employees added to the White House staff?

Dr. Tyson. I believe that 50 new employees must be made up in some other place, because the total size of the staff, including organizations like CEA, is a 25 percent cut.

Representative Cox. Do you disagree with Leon Panetta's $9 million number for the amount of the cut?

Dr. Tyson. The estimate of the savings that comes from reducing the staff by 25 percent, if that is Director Panetta's number, I would adhere to that. He is the person who has budgeted all the numbers with actual amounts, and he has been very specific and very unwilling to accept gimmicks. If his number for that saving of 25 percent staff is that number, then I believe that to be a credible number. He has done all of those estimates.

Representative Cox. I would caution against using that 25 percent figure.

Dr. Tyson. It is a 25 percent staff cut, and that is a real number. That is how to report that number.

Representative Cox. Newspaper reports are telling us that there is new staff being added. I yield back my time.

Dr. Tyson. That is the issue of staff being added someplace and reduced-the White House is not going to be organized the way it was in the past. So we have a change saying how the environmental group is going to be organized. We have the creation of the National Economic Council. We have a reorganization as well, so the notion is that you have to look at the reorganization and the total number of staff. It is the overall staff that is being cut. Lawyers may be added here, environmentalists added there. There will be reductions elsewhere.

Senator Dorgan. Would the gentleman yield? My assumption is that they are probably adding Democrats to replace Republicans now at the White House.

Representative Obey. Senator Bingaman.

Senator Bingaman. Thank you, Mr. Chairman. Dr. Tyson, welcome. I am glad you are in this position.

Let me ask you a couple of questions about the package. The reduction of federal pay retirement benefits, does that apply also to the military?

Dr. Tyson. No. This is for federal employees not including the military.

Senator Bingaman. In the past, we have always had a little debate about whether it is appropriate to freeze or cut the pay of civilians while the military folks working side by side with them continue to draw a full cost-of-living adjustment. Did you folks discuss that? Is there a reason why the cut was limited to civilians?

Dr. Tyson. Well, we have a very significant set of reductions planned overall for the military, and that part of our deficit reduction program is really estimated to be about $37 billion. We will be working with Secretary Aspin on the specifics of that.

One of the things that we were constantly struggling to achieve was balance, and it seemed to us, with the reordering of priorities within the military and the size of the cut that the military was going to undergo, this was an appropriate balance.

Senator Bingaman. On the issue of the package of tax increases that are contained there, I have been somewhat concerned that even with this package, if this were duly adopted and put in place, we are still faced with the very real prospects of having to raise revenue to finance the reform of the health-care system. Has there been thought given to how that happens and how whatever we do in that area fits in with what is being done in this package on the tax side?

Dr. Tyson. The way we thought about that problem was a little differently. We asked ourselves what in Medicare, what in the current health care system, we could do that would be consistent with any long-run health-care reform we could imagine.

We felt that there were two things that we could do. In our investment package, we could spend on certain initiatives that we needed to spend on regardless of what system we put in place, such as drug abuse or immunization. We also felt we worked very hard with Health and Human Services to come up with a set of Medicare provider adjustments that would be consistent with anything that we were going to do in long-term health care. That is as far as we felt that we wanted to go right now. We felt that health care itself was such a significant issue, in terms of structural reform and being phased in gradually over several years, that it was important to treat it with a little longer time schedule than this package.

SENATOR BINGAMAN. I am just keying back to the President's speech last Wednesday where he says it has to be done this year.

DR. TYSON. I meant, instead of making a proposal now that included health care, we are going to come up with a proposal in late spring. A little longer in this Administration may mean two weeks in terms of——

SENATOR BINGAMAN. My concern is, if we go forward to adopt the package as it is laid out on the revenue side—and I understand what you are trying to do on the spending side—but on the revenue side, if we go forward with the package, and in the late spring we get a proposal to substantially increase funding for health care to take in the 28 million or however many million people there are out there without any coverage, how does that fit in what we are doing here and how does it fit when applied to a particular business entity that is going to the 36-percent bracket now, and then in the late spring would be asked to pick up the health-care costs?

DR. TYSON. I think that the most important thing to say about this is that we believe that the health-care reform package, if we structure it correctly, will result in tremendous savings to the domestic economy, to private businesses who have to bear huge and increasing burdens of providing health-care services, and to self-employed individuals who have to do this. We believe that if we address the health-care crisis in a serious way, we will actually generate in the economy very significant savings that will be the source of funding for gradually phasing in excess for the uninsured.

So we are not thinking of a system where we don't get any savings. In fact, the President emphasizes repeatedly in his discussion of health-care reform the need for significant savings on the cost side. That is really what we want to use as the mechanism for providing enhanced coverage for those who are currently not covered.

SENATOR BINGAMAN. Thank you, Mr. Chairman. My time is up.

REPRESENTATIVE OBEY. Senator Bennett.

SENATOR BENNETT. A few quick comments, Dr. Tyson. I, too, welcome you and congratulate you on your assignment. I was happy to vote for your confirmation and look forward to great things from you.

I suggest that you might want to check this morning's *Washington Post*. It says that the transition team working on health care has told the President that there can be no reform subsequent to 1997, the year after he leaves office, if he doesn't win reelection without a major increase in costs—and by major, they are talking about $170 billion. For you to sit here and talk about significant saving coming up in the short term is something that is a little bit scary in view of what the President is being told in this area.

But I don't want to quibble with you about whether there is smoke and mirrors and budget gimmickry. My own feeling is that there are, of course, and there always have been and always will be. The *Post* said Friday:

> The reason they are talking about a billionaire surtax is that this Administration does not want to admit that the top marginal rate is 40 percent. They want to say that the top marginal rate is 36 and then there is a 10 percent surtax that, for certain people, brings the rate up to 39.6, and with changes in the tax credit it goes over 40.

I would have preferred that the Administration had said that the top rate is going to be roughly 40 percent.

The issue I want to focus on is a comment you made when you talked about our tax burden being under the rate of other industrialized countries. The studies I have seen indicate that that is true, if you take tax burden at the federal level only. When we add the tax burden of state and local governments to the tax burden of the Federal Government, we get to the point where the percentage of gross domestic product being taken away from business people and individuals indeed approaches, if it does not exceed, that of other industrialized countries.

I believe, and I hope you will address this, we must add in the unfunded mandates as a governmental cost. It is not a specific tax that the economists can come up with, but a governmental cost of doing business.

As I was campaigning, the thing that I heard over and over again from mayors and state legislators was that the Federal Government is going to break us by giving us mandates that have very definite costs attached to them, but no money with which to meet those mandates. Thus, mayors and state legislators are forced to do one of two things: Raise taxes ourselves at the local level so that the Feds get the credit for new benefits and we get the voter hostility for higher taxes, or cut services.

I just got a letter from a university president who is stepping down as president of his university for one reason only. He said:

> I can no longer handle the mandates that I am getting from the Federal Government that are destroying the financial capabilities of this university to survive. And I am going back into the classroom and teach. I can't handle the hassle any more.

Do you have any studies or any handle on what the total cost of government is in this country—not just federal taxes, but state taxes, local taxes and the cost of complying with federal mandates, which are a form of taxation. Do you have any comparison between the cost in America and the cost of governments in other industrialized countries?

Dr. Tyson. There are several reactions I could have to that. First of all, on the issue about comparative tax rates, the specific one I was talking about was actually corporate income taxes and looking at the notion that the U.S. corporate income tax rate is lower than that in Japan and Germany, and in several of the other advanced industrialized——

Senator Bennett. I am aware of that.

Dr. Tyson. So you know that, okay. I do want to make clear that that was the comparison I was using. It is my understanding— and I will be happy to check these numbers—that even if you add state taxes into the

picture—I don't know about local ones—if you do state and federal collection of taxes as a percentage of Gross National Product, an overall estimate of tax burden, the United States is still at or near the bottom of the advanced industrial countries.

Now, to go back to an earlier question, because other advanced industrial countries usually have a large value-added tax system in place and they are often using that to finance some of their health-care services, but nonetheless, the United States does, even with the states, show up at the bottom, in terms of overall tax burden.

Individual localities, I don't know, and certainly there are lots of variations across states. To get to your second question, I believe this is of great concern to the President. The President was, after all, a governor and as a governor, he had to confront this important problem on a daily basis—environmental and health-care mandates, in particular. In fact, what is driving state budgets into crises, if you look around the country, is often the health-care mandates without the funding. So the reason he is so compassionate about health care is because as a governor, he saw what it was doing to state budgets, given mandates. So I think you have a President who is going to be very concerned about that. In fact, if you look at this package, any part of this package, there is nothing in the package that really shows up as an enhanced mandate on the government. It is actually to give investment funds, to give community bloc development grants, or to be involved in funding for infrastructure projects that would help the states.

Senator Bennett. If you could try to do some studies on the cost of mandates, I would appreciate it. Let me move very quickly to another issue. One of the things I feel strongly about and that I keep running into as I get into government is that the economy is not a mathematical model. The economy is organic.

We ought to be thinking of it in biological terms rather than in mathematical terms. That is, if you snip something off here, it produces some kind of a symbiotic relationship or reaction over there.

Let's talk about the energy tax. You said in your testimony that it would discourage dependence on imports. We keep hearing that, "Gosh, if we just raise the gasoline tax, then people will stop buying oil from Saudi Arabia." Frankly, I have real trouble with that given the amount of investment we have in that sort of gasoline-based system. We can't automatically shift to riding the railroads until we make a massive investment in railroads. Since we have already made a massive investment in the interstate highway system and the primary and secondary roads that feed it, we will still buy oil from Saudi Arabia regardless of the energy tax.

However, have you done any studies, or have any information you can share with us, on the ripple effect of this specific proposal? We saw what the economists call the oil shock of the 1970s, when the cost of oil went up and a tremendous dislocation occurred throughout the economy as a result of vastly increased prices for oil.

We are not just talking about the suburban commuter and what he or she has to pay on the way to work. We are talking about increased trucking costs, which means increased costs in the supermarket for all of the goods that are brought there by a truck. We are talking about a whole range of ripples in the organism that is the economy, which I do not find in the studies I have seen that seem to treat the economy as a mathematical model.

Do you have any information you could share with us as to what the overall effect of this increased energy tax might be? Before you answer, let me make it clear that I am perfectly willing to look at any kind of solution to the deficit problem. I think that what you are saying about the need to get the deficit under control and about the benefits that come with lower interest costs is very, very valid, and I salute the President for taking a serious run at this. I must confess, as I look at the specifics in the proposal, I get nervous because many of them sound very much like the same things we had three years ago in the 1990 budget summit when we were also told that with sacrifice and pulling together, we could finally get the deficit under control. And this is not an ideological matter. The budget deal fell apart for a variety of reasons.

So I am not throwing rocks at the President. I am giving him an "A" for effort, but I am concerned about the ripple effect of the energy tax and the fear that it might, in fact, produce more problems in the economy than it will solve. With those problems come lost jobs, returning to the image of the organism again, side effects that we weren't expecting when we raised taxes. Do you have any information on that?

Dr. Tyson. Sure. The first observation I want to make is that this is a relatively small energy tax. It is broad based, but it is relatively small. If you look at the dislocation caused by the oil price shocks of the 1970s, in the early 1970s you had a 400 percent increase in the price of oil, and it was very sudden. No one had time to adjust, and furthermore, it is very hard to adjust to a 400 percent price increase, even if you have several years.

By this energy tax, we are looking at price increases in the order of 3 to 8 percent. So this is not anywhere near the order of magnitude of the 1970s.

Senator Bennett. The flip side of that comment is, of course, that if the tax is that modest, it will have no effect whatsoever on the things you talked about on the deficit.

Dr. Tyson. We have done some estimation on this. It will result in some conservation, some reduced use of energy, it will result in some reduced emissions, and I can share the numbers with you.

Senator Bennett. I would love to see them, yes.

Dr. Tyson. Let me say, we were sensitive to the issues that you have raised. We thought that the energy tax should be phased in. In addition to being a relatively small tax, in terms of its long-run impact on prices, it is phased in gradually over a three-year period. This is to give people

time to make some adjustments in how they insulate their house, in travel patterns to work. Utilities can make some adjustments in terms of the composition of the kinds of energy they use as inputs into providing electricity, so we have given time to make the adjustments.

In the 1970s, in response to that 400 percent increase, we did see that in fact there was a change in how airlines behaved, consumers behaved, truckers behaved. People do adjust their spending patterns over time in response to a change in relative prices. So we do think that there will be some related effect, but we are not going to subject the economy to a shock that would result in a significant increase in prices or in a significant reduction in output.

Indeed, we believe that this energy tax, combined with the interest rate reductions that we expect from deficit reduction and all of the enhanced investment credits that we are giving to the private sector, that indeed the private sector will be stimulated by our package. It will not be discouraged by the package. So you have to look at the whole thing, but keep in mind that we have made this energy tax sensitive to the kinds of concerns you raised.

Let me say one other thing about the energy tax, which I didn't mention. Another area where the United States is comparatively out of line, if you will, different from its advanced industrial countries, is the extent to which we tax energy. We have much lower taxes on energy than any of the other advanced industrial countries. In this particular tax that we are proposing, the Europeans have offered to consider seriously a similar tax in response to our initiatives so that we may actually get some movement on some of the commitments that were made in Rio on emissions as well as a side benefit to this. So I think we structured it in a very balanced and judicious way over time.

Senator Bennett. Thank you. Mr. Chairman, my time is expired.

Representative Obey. Senator Dorgan.

Senator Dorgan. Thank you, Mr. Chairman. Dr. Tyson, it is nice to have you before the Committee. I don't think the question is when; the question is exactly what we do, and I give the President an "A" for effort, and also think it is important that we move it through this Congress quickly. I think all of us probably have some recommendations for adjustments here or there. Nonetheless, I think our goal at the end of this year is to have moved a very substantial package through this Congress that relates to the President's suggestions in reducing the deficit by reducing spending, increasing some taxes, and also providing some new investments and some stimulus.

Have you done any analysis of the regional impact of these sets of proposals offered to us by the President? Some would say, and I tended to think with some validity, that western and rural areas are going to be harder hit as a result of a couple of the provisions—agriculture and energy provisions—than are other regions of the country. Have you done any analysis of the regional impact of these recommendations?

Dr. Tyson. We have tried very hard to think about regional impacts in the choices we made. So let me just talk about this in terms of some specifics. We considered alternative kinds of energy taxes. for example. and-

Senator Dorgan. Did you consider an oil import fee. for example?

Dr. Tyson. Yes. We looked at the whole panoply of possible energy taxes and one of the significant factors in favor of our choice was that it was the most even across regions and energy types. So we really weren't going to disadvantage a particular region of the country or a particular energy source disproportionately. That concern was one of many concerns we considered.

Let me talk about some other issues. We thought very hard about a rural versus urban balance. and we have in our initiatives. in our investment package and in our stimulus package. there are rural investment initiatives or wastewater initiatives or conservation initiatives that we believe are important for the future development of rural communities. So some subsidy reduction that we felt no longer served a purpose. or a fee increase that we felt had been provided at an exceedingly low fee, we made adjustments there. At the same time that we were making investments. we were putting together a package that really served those communities as well. So we thought about rural and urban.

Finally. in the investment package. we often focused on needs that we thought all regions of the country would benefit from if addressed. so education needs or infrastructure needs. these are meant to be widely dispersed across the country serving a wide range of communities.

Senator Dorgan. Well. there will certainly be lot of discussion about that in the future. I am sure. Dr. Tyson. one of the concerns that the President has had is about the creation of jobs, and even as we are recovering. it appears that the job creation of this recovery is not very robust. and so the issue is jobs. It is interesting to me that if you, as a business person, would have an opportunity to hire a machine or a person to do an equivalent job at an equivalent cost, you would have to take the machine. because the machine comes with a tax benefit and the person comes with the clothes hanger of enormous social costs levied in the manner of payroll tax. I have wondered whether other countries do the same. with respect to the rest of the countries in the world, as we try to encourage the creation of a job. The act of creating a job by someone who creates it, is to say that we are going to assume the responsibility for an enormous number of these new costs that are clothes hung onto this job creation.

I am wondering whether you considered a broad-based consumption tax as an opportunity to probably move away just a bit from payroll taxes. The President commented a bit about consumption taxes the other day in a couple of different ways. Did you consider a broad-based consumption tax in the long-term? And if you rejected it, why did you reject it?

Dr. Tyson. Let me answer that particular question last. I just want to go through your question up to that point and then I will answer it. because I agree with you that we do, by the nature of our system, make it more difficult for people to take on a permanent employee. We think of that primarily as a health-care issue now. I have to say, the notion of bringing on someone other than a temporary worker forces you to confront immediately the issue of how to provide health care.

So our whole notion of the main thing that we can do is to try and reduce that cost in some way, and that is really why health care is so important. The second thing we don't do a good job of, in terms of enhancing the attractiveness of making a permanent employee, I don't think we do is a very good job of training and education. So, if you take our students who are not college-bound and look at their educational skills at the end of 12th grade and then compare those skills to noncollege bound students in other advanced industrial countries, our students have poorer educational achievements at the end of 12th grade.

In addition, we don't have conduit training systems or apprenticeship systems in place to move people into a forum whereby they could get the appropriate training to go into, so we are thinking of trying to work on that part of the puzzle. So health care and training are important ways to bring people into the system.

Now, as far as the specifics, should we consider changing our tax system from one of sort of employment-based tax to some extent to a value-added tax, we have not had that discussion this round. I mean, we were looking for a package of proposals that would handle the three challenges that we felt we should confront head on.

In the next several years, we probably will work with you and other Members of Congress to think about whether or not the United States should be moving in a direction towards some more use of value-added taxes.

Senator Dorgan. My time has expired. For the record, we should point out that health insurance or health costs are one element of payroll taxes, but you have unemployment, workmen's comp, social security, health, and the HI tax. You have a whole range of social costs that you hang onto in the creation of that job.

Dr. Tyson. That is true. Although I will say, in comparative studies around the world, one thing the United States is usually viewed as very flexible is in is the employment relationship. We have a lot fewer regulatory restrictions on hiring and firing, for example. We have a lot fewer regulations on the employer should he or she bring on an employee, so our system actually is viewed to be quite flexible in that relationship compared to, say, the European countries.

However, the reason I emphasize health care is because our flexibility is quickly diminishing because of health care. It is the health-care thing that has exploded. The other areas have not exploded relative to the cost of bringing on an employee. It is the health-care costs that have exploded.

Representative Obey. Senator Robb, please proceed.

Senator Robb. Thank you, Mr. Chairman. Dr. Tyson, thank you for joining us this morning. I share some of the concerns that you have heard from other Members of the Joint Economic Committee this morning. With respect to the mix, let me preface my comments by saying that I, too, applaud the President for dealing with some very real numbers and making some very bold and challenging proposals, which I think clearly moves the whole equation in the direction that many of us have wanted to see it move to for quite some period of time.

But the change in the relative percentage of reductions in spending to tax increases, there was some hope on the part of many of us early on when the CSIS proposal, which Sam Nunn and Pete Domenici chaired was put forward, and I think that was the one that had a 2.7 to 1, in terms of reductions in spending, as compared to tax increases. Then reference was made already this morning to the possible relationship that Leon Panetta and others had talked about hoping to achieve a 2 to 1. Then there was a great deal of talk during the last day or two, before the President formally made his State of the Union message last Wednesday night, that it would be closer to 1 to 1, and in each subsequent revelation, we see a change in the relationship to the point where it is now almost flipped from where many of us had hoped it would be with respect to spending reductions or spending cuts.

Could you just address the dynamics in terms of benefit to the economy or long-term benefit, or wherever that might fall within the general purview of the Council of Economic Advisors, with respect to what relative benefits flow from either more decreases in spending or more increases in taxes?

In other words, just generalize a little bit in terms of the effect on the economy and then if you will, so I can put it all into one fairly substantial question, would you talk just a little bit about the paths not taken? I know that is always difficult. I kidded Leon Panetta moments after the State of the Union speech, and he gave me a friendly look, and I knew that I was hoping for things that did not come to pass. He is a good soldier and you can't spend too much time talking about the paths not taken. But I wonder if you could talk a little bit about some of the big items which were not selected that might have led to the ratio that many of us had hoped could be achieved, and give me an indication of why they weren't selected.

Dr. Tyson. Okay. First of all, in the ratio, I don't believe that the ratio has flipped. I just don't believe that. Even if you listen to the exchange I had before on social security, even if you score that, I think conceptually that my argument is defensible, and I believe that if we took those benefits away in a different form, we would just call them government spending. But if you want to score it the other way, score it the other way. You still get a changing ratio over time. It does change over time because of the phase-in of both the spending cuts and the tax increases, but the phasing in, if you go into the out years, is actually more spending cuts than taxes.

Senator Robb. You can understand why there might be some degree of skepticism here and around the country about the effect of out-year proposals, as opposed to the effect of the current within the jurisdiction of any given Congress-type proposals.

Dr. Tyson. Yes, I can indeed understand that and that is why I am sure you also heard Director Panetta—he has educated me a lot—talk about the need for a very credible enforcement mechanism and what he thinks that would consist of. Because we need to have this as an entire package written into law, with credible enforcement mechanisms in place, so the American people can believe that if indeed there is a spending cut, which is supposed to come in 1995 at this amount of billions of dollars, it in fact will occur in 1995, or if it doesn't occur in 1995, there will be a cap that forces you to cut something else instead.

So, yes, I think that credibility is actually essential. We try to achieve it in two ways. One, being specific about the item and the time trajectory of its being cut; and two, to try and include it in a large bill that would have enforcement mechanisms that the American public can believe in.

Senator Robb. Admittedly there is far more candor in the presentation than I have seen. I am not even quibbling over whether you want to put the social security cuts in as a spending reduction or tax increase at this point, but tell me why I shouldn't be a little bit concerned that the ratio is not 2.5 to 1 in terms of spending cuts to the federal——

Dr. Tyson. That gets to your second question, which is, we have to look at the overall objective. The overall objective is a credible amount of deficit reduction; an amount that is big enough to reverse the trend of increasing deficits over GDP; an amount that is big enough to get the debt GDP ratio down; an amount that is big enough to convince domestic and international capital markets that we are serious, and therefore we will get, and we have already gotten, some long-run interest rate benefits.

After all, we are doing this to get investment resources to the private sector at a more attractive rate. That has already happened just in anticipation. So my commitment is to the overall objective of deficit reduction.

Now, when you go into the process of trying to figure out how to do it, the economical objective is deficit reduction, and I would say that we looked through a long list of possible spending items. We looked through a long list of possible revenue items.

One thing that was off, and we did not consider, except insofar as we did some Medicare consistent health-care reform cuts, is, if you look at the spending cuts, I think it is important for people who want to emphasize spending cuts as a option that they look at the reality of what the spending is. Spending is interest payments on the debt that have been rising over time and we cannot renege on. Spending is social security that has been a constant fraction of GDP. We did some social security adjustments that have stabilized that as a percentage of GDP. Spending

is nondefense discretionary that has been on a downward trend since 1980, a significant downward trend since 1980. Spending is defense, from which we are asking $37 billion.

It is one thing to opine about the need to have a certain ratio. It is another thing to look at what spending really is and to come up with that ratio. We encourage people to do that, but if you come up with a proposal to cap health-care costs and just say that we are going to save $150 billion, but we don't know how, that is not real. That doesn't tell me what we are really going to do. That is less credible than saying we are going to take this particular item in Medicare and we are going to do this with it over the next five years.

So I think that we encourage the notion of additional specific proposals for spending cuts, but I suggest that when you go and look for them, what you discover is the reality of what the government is spending money on, and you try to cut back those things that you think no longer serve a purpose, things you are undercharging for. They are inefficient. You look for something to cut that you can cut.

Senator Bennett. Mr. Chairman, would the Senator yield on that point for just a minute for a clarification?

Senator Robb. Please.

Senator Bennett. Quoting——

Representative Obey. He doesn't have much time to yield.

Senator Robb. I was going to say, my time expired and I was——

Senator Bennett. I am sorry.

Senator Robb. That is all right.

Senator Bennett. Congressman Hamilton quoted from this morning's *Wall Street Journal*, right on the Senator's point, and the point you are raising, because you said, "Gee, there isn't anything else."

Dr. Tyson. I didn't say that. I said it is very hard when you start with a ratio.

Senator Bennett. If I may quote from that article which Congressman Hamilton quoted, which is on the point that Senator Robb is raising with you. It says:

> Budget director Leon Panetta and his deputy, Alice Rivlin, made an attempt to take more out of those benefit programs by proposing a one-time freeze in cost-of-living increases, made to counter the effects of inflation. To protect the poor, they proposed giving full cost-of-living benefit increases to those at or below the poverty level; others would have gotten a benefit increase limited to the dollar amount given those at the poverty level.
>
> But even that modest proposal was rejected. Those on the President's economic team who championed investment spending lost their stomachs when it came to cutting consumption spending. 'Leon and Alice,' said one budget official, 'ended up with tread marks all over their faces.'
>
> While it is still far from the radical realignment of spending priorities that candidate Clinton promised, the result is a plan that reduces the deficit largely through tax increases."

I think that is the point you are making.

Senator Robb. Mr. Chairman, if I may conclude, I know my time is up. I have not seen this article, but it gets directly to the essence of the question I am asking, and I asked in a friendly sense. I plan to support the President and I applaud him for being far more specific, using far more realistic numbers than have been used in the past. But like many of my colleagues, I express some disappointment that at least the ratio of spending cuts in some of the proposals that we have all talked about didn't end up in the final package. I didn't really expect to get a complete stream of consciousness in terms of why we can't do certain things, and I can't suggest that political considerations can be entirely ignored. If they could, we could design a much more efficient government than we have today. But it is clearly something that is troubling many Members of Congress today, and I would suggest, Dr. Tyson, that anything you can do to assist us in grappling with this particular concern will assist us in providing the kind of fulsome support, which I know the President needs and expects from the Members of Congress in order to move this veritable program forward.

Dr. Tyson. Let me say what I said at my beginning statement. Not only do I think but I feel that we should encourage the opportunity to work with the Congress on additional proposals for spending cuts, provided that they are real and that they are as specific as the ones that we have proposed.

We are committed to the overall size of the package. We are committed to the notion of some balance across regions, across income types. We are committed to some balance between revenues and expenditures, but we would be happy to talk about some additional spending increases, and I think the reason you got to the stream of consciousness is because in part——

Senator Robb. I think you meant to say spending cuts. You said spending increases.

Dr. Tyson. Spending cuts, yes, of course. When you sit down and you try to do this in a very detailed way hour after hour, you realize how hard it is to find spending cuts.

The proposal that was made by Director Panetta and Alice Rivlin, when you netted out the amount of money that you would put back into the system to protect people from falling into poverty as a result of that, it was a very small number. And you could argue that you want to do it on principle, that you want to do it on principle on the issue of shared burden, on the issue of sort of progressivity, that you want to do it. But the number you get there would not change this ratio problem, I assure you. The COLA adjustment with protection for people so that they don't fall into the poverty level would not change the ratio. It is just too small a number.

Representative Obey. The Senator's time has expired. Thank you.

Dr. Tyson, let me get to my questioning now. You know, I have to confess that I really believe much of this discussion this morning

sounds like another rerun of inside baseball inside the Beltway. I am on Third Street in Warsaw, Wisconsin, my hometown. I don't find people grabbing me and saying, boy, I hope you guys get the right ratio. What I find them saying is what Mr. Perot said, fix it, fix it, and it seems to me that that is the way we ought to look at this package: Does it fix it or doesn't it fix it.

If you take a look at the projections for deficit reduction, it seems to me that if you can get the deficit down to half of its present level as a percentage of GDP, that you indeed are taking a very large step in fixing it.

I think that is what the public wants to know, especially when the lion's share, 70 percent of the revenues that are being talked about, are going to fall on the shoulders of people who are in the income tax bracket of a Member of Congress, $100,000 or above. I think that is a pretty good division of labor, if I might say so.

You know, I come from Wisconsin—Vince Lombardi country—and his theory was, just get the ball over the goal line, just get it over the line. Don't bother me about whether it is a pretty play or a gunky play so long as you get it done, and that is what we ought to be focusing on. Will this get the job done, not does this fit our pet political speech back home, or does it fit our pet political theory, but does it get the job done one way or another with a reasonable degree of fairness. And that is, I think, all the American people are asking.

Dr. Tyson, with respect to the question of whether social security changes should be counted as a tax increase or spending cut, are you aware of the fact that in 1983 when the Greenspan Commission first suggested the imposition of the 50 percent taxation rule for seniors, President Reagan called it a spending cut.

Dr. Tyson. I didn't know that.

Representative Obey. I think the term used at the time was "reduced effective benefit."

Dr. Tyson. Reduced benefit.

Representative Obey. Or effective reduction in net benefit. Those were the two terms that were tossed around, and I know because I wrote them down when I was in those discussions.

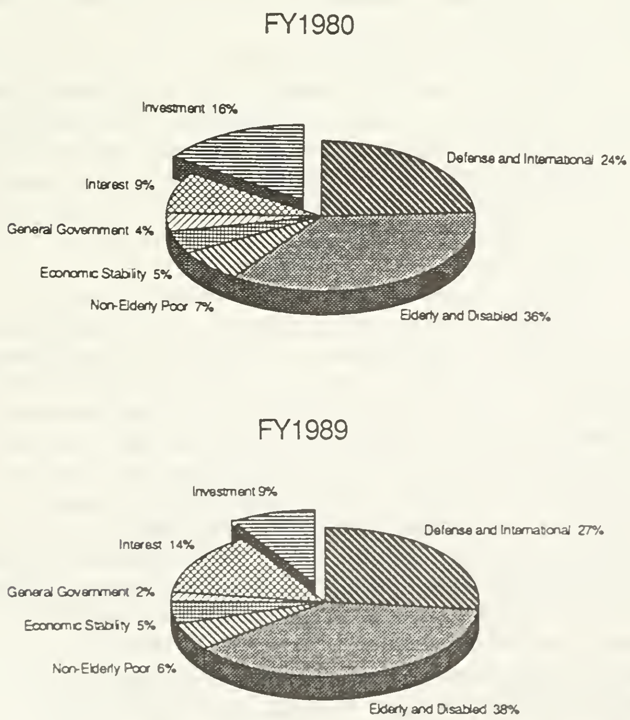
I would like to ask you about the need for stimulus, because as you know, some people are saying, don't need it, already got the recovery. I will admit that I think President Clinton's election alone did a lot to restore consumer confidence. I think that any time you have the election of a new president, people want to hope, and I think this was no exception, so one of the reasons that you have higher consumer confidence numbers is because we have a new president, and people think things are going to be different.

But I want to ask you about the need for a stimulus. You indicated the troubling problem of the number of unemployed who are permanently unemployed. This chart demonstrates, I think, a significant difference between this recession and previous recessions.

In previous recessions, you can see that this gray part of the chart has very large peaks representing increases in temporary layoffs in 1975, 1982. As you can see, from 1984 on in this economy, you don't have those big increases in temporary layoffs. Since 1991, you do have a huge increase in permanent layoffs, and as Congressman Gingrich pointed out when he responded to the President's initial comments on television before his State of the Union message, there are already announced some 250,000 pending job layoffs over the next months and years. If you take a look at surveys that have been made of Fortune 500 corporations, you see that they are indicating that sometime in the next two or three years, they are planning to lay off several million people. So it seems to me that your concern about stimulus is important.

With respect to the need to invest, I think this chart demonstrates the wisdom of what it is that you are trying to do. This pie chart demonstrates the way the budget dollar was divided in 1980, with 16 cents out of every dollar going for investments, and I don't mean consumption. I mean investments in education, in health research, not delivery, in science, in physical infrastructure, all the rest. (See chart below.)

Composition of Federal Outlays



Today, as a percentage of the federal budget, that investment piece of the pie is down to less than 9 percent. That is a 40 percent relative drop in investment, and I don't know many corporations that would function very well long-term, if they had that kind of a continued drop in investments.

I want to ask you about one piece of that investment package. As you know, the Heritage Foundation is suggesting that they have minimum high regard for infrastructure investment, especially in highways. I would like you to lay out, if you would, the economical rationale for including the transporation/highway piece that you have included in the stimulus package.

Dr. Tyson. Okay. First of all, I want to say thank you for that Reagan anecdote. We actually had discussed this issue of the benefit in social security, but I guess no one had been at the meeting you had been to. I appreciate that.

On the stimulus package, just let me give you some of my reasons why I think, economically speaking, a stimulus makes a lot of sense. Let me just start by saying that we are 4 percentage points under our productive capacity, and that private-sector forecasts, which don't build in the stimulus, suggest that we won't get to our capacity until 1998 or 1999. This is a tremendous amount of lost output. We really have to do something to get there more quickly.

Second thing is, we have had a recovery that stalled once already, and it can stall again. If you think about people's confidence, for example, people's confidence is partly based on the notion that they expect this President to do something. The President said he would do something. He would do something upfront to stimulate the economy. If there is no action, then that can really very quickly undermine investor and consumer confidence, and so we may want to make sure that we don't have another stall.

Another thing that is going on is that the rest of the world has slowed down. During the Bush years, the overwhelming share of growth in this economy came from export growth, and the export growth came because the rest of the world was chugging along at a growth rate faster than ours. We can't depend upon that now, and therefore we have to think of ways to get our domestic economy moving more quickly. Finally, let me just once again say that we have looked at the numbers very carefully, and if you do a very careful statistical analysis comparing this recovery to previous recoveries, three million missing jobs is approximately the correct number. That is how many we don't have relative to our past performance. Those are real people without real jobs. So we feel that we can afford a modest stimulus package, and we should take the opportunity to help the economy recover.

It is important that the economy be on a robust recovery track when we introduce deficit reduction. We want a robust economy to absorb increases in revenue and decreases in spending. We want an economy

that is moving along, the private sector has enough forward momentum to keep us moving through this process, so as the government cuts back in the economy, the private sector moves forward.

Representative Obey. What is the economical utility of infrastructure investment, especially transportation?

Dr. Tyson. That is an argument for having a stimulus, the composition of the stimulus, what you include in it. We were looking for items that we believe affect the long-run productivity of the private sector. There is study after study not just in the United States but internationally showing that public spending on education, on technology, and on infrastructure, both sorts of physical and now increasingly information infrastructure, actually enhances the productivity of the private sector.

What the private sector can get from its own investment is enhanced or increased by the foundation that it works with. So the argument for having infrastructure in the investment package is that we know it will add returns to the private sector.

The argument for having it in the stimulus package is that we know infrastructure spending creates jobs and it creates high-wage construction jobs. Furthermore, because we have the ISTEA legislation and a series of projects that have not been put underway by state and localities because they have been so hamstrung by mandates and health-care spending and all the rest, we know that these are projects that can actually be initiated very quickly. So we expect a quick effect, a high-wage employment effect, and then adding to productivity over time.

Representative Obey. I would like to make another point with another chart. One of the things that bothers me, and I have heard it three times since the President's package has been announced, family income has still been rising. People are debating that issue, but I think we have to show why and how, because what happens is that people who make the argument about the rise in family income over the 1980s being sufficient tend to point to this green line that shows what has happened to, quote, family income. If you subtract from what appears to be an escalating income, the income generated by sending a second worker into the work force in the form of, usually a wife, then the red line demonstrates that since 1973 we have had no real gain to speak of in primary earner income. It just seems to me that that, again, demonstrates, in terms of the interests of an average family, why it is necessary to do something to boost that investment portion of your budget.

Let me ask you one question. As I understand, the GDP is expected between now and 1988 to experience a cumulative growth of about $5.6 trillion. Now, if you take all of the revenues that the Administration is suggesting be raised over that time, isn't it true that of the total increase in GDP, the increase revenue that the Administration is asking for is less than 6 percent of the entire GDP growth?

Dr. Tyson. Yes, that is true. Basically, we are leaving to the private sector a little more than 94 percent of the growth that we generate, which we believe would not be generated without this package. This

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growth is coming from deficit reduction and lower interest rates, government investments and enhanced productivity and the economic stimulus, so we are getting a growth dividend here which we are giving primarily to the private sector.

REPRESENTATIVE OBEY. One other point for those who are worried about the truly needy millionaires of this world, this chart, again, I think, emphasizes the different arguments being made in the debate about taxing the wealthiest 1 percent. The argument is made, well, gee whiz, why are you beating up on the richest 1 percent or the most well off 1 percent; after all, they are paying a larger share of their total revenue than they were a few years ago.

This chart demonstrates that in 1977 the top 1 percent, on average, was paying $108,000 in taxes. That has gone up to about $163,000 in taxes today, on average, for the top 1 percent. But that is on an after-tax income, which is up to double that amount or more, a 50 percent increase in their federal taxes, but over 100 percent increase in their income, because their after-tax income has gone up on average from $197,000 to $566,000 today. Not bad.

So I hope that you are not too shy about defending that top rate, whether it is regarded as being 36 percent, or 39 or 40 percent for that top 1 percent. I don't think anybody has anything against millionaires. I think we would all like to see everybody be a millionaire. But I do think we feel that they can afford to pay their fair share, and this chart certainly indicates they got a little room to go before they hit that ceiling.

I would like to ask you two other questions. If you were talking to a businessman on Main Street in my hometown who was skeptical about increased taxes, no matter who they are on, he is skeptical about whether this package would really lead to the kind of economy that you want to see, what would you tell that businessman? Why is this package good for the average mainstream businessman in this country?

DR. TYSON. Okay, I think I would first emphasize that this package is meant to be a pro-growth package. We are going to have some initial tax incentives for businesses, both small and large. We have crafted the tax incentives to really reach down into the small business community, through the investment tax credit for the small businesses and through the capital gains tax relief for the creation of new small businesses. So we are reaching out to both large and small businesses with tax incentives to enhance their investment and profitability.

I would say that we are also providing them with infrastructure investment, with better trained workers, with civilian technology programs for businesses adversely affected by defense scale-backs; that we have a defense conversion initiative that we are going to be funding and organizing so that there are a variety of things that actually go directly to the business community. In addition to which, deficit reduction will lower interest rates. They already have significantly lowered interest rates.

I think there is an important point to be made here. The interest rate now on government 30-year securities is the lowest since its initial offering. We believe that we are going to fundamentally end up with changing more than a decade of 4 percentage points real interest rates down to three. We believe that we are going to be giving a tremendous boost to the private sector as a consequence of our scaling back the claim the government has on society's invisible resources.

This is a tremendous bonus to the small business person trying to get a loan. It is a tremendous bonus to the individual household trying to get a mortgage, to the individual student trying to get a loan to go to college.

So that benefit is very large, and you can already see it in terms of where interest rates are. So I think we have some direct things for the business communities, some indirect things, in terms of enhanced government spending and these interest rate benefits.

Representative Obey. I would like you to comment on a story that appeared in, I believe, *USA Today* this morning, which indicated that there are some people who are suggesting that this overall plan may not be, quote, "Pro-growth." That is certainly not the way I see it, and let me stipulate by saying that I think President Reagan honestly believed that the package he was promoting would be pro-growth. We saw that we had growth for a while but at tremendous cost in terms of debt, in terms of sliding family income, in terms of long-term interest rates, all the rest.

I would like to get your specific response to what I consider to be a quaint interpretation of the Administration's package. Why is this package pro-growth?

Dr. Tyson. Well, I think it is pro-growth in three ways. One is that the stimulus part of the package is obviously pro-growth. It is obviously through tax incentives and spending increases that will create jobs directly. It will create dynamism in the American economy in a very predictable way.

The second part of the package, the investment part of the package, is pro-growth in the long run because we are adding investments that are productivity enhancing and output enhancing for the private sector. In addition to which, our long-run investment package contains a series of tax initiatives that will stay in place. For example, the small business tax credit for investment will stay in place. The capital gains tax provision for small businesses will stay in place.

So, again, we are emphasizing growth through the investment package by encouraging public investment to enhance private productivity and private investment directly through tax incentives; and, finally, deficit reduction is pro-growth. Going back to what I said in the beginning, the only reason we need to be for deficit reduction is because deficit reduction will stimulate long-run growth in productivity and living standards.

How does it do that? It does that by reducing the claim of the government on society's invisible resources. Then private investors can invest more. That is the key to our productivity and growth. So we believe this is a short-run pro-growth package through stimulus and a long-run pro-growth package through investment and deficit reduction.

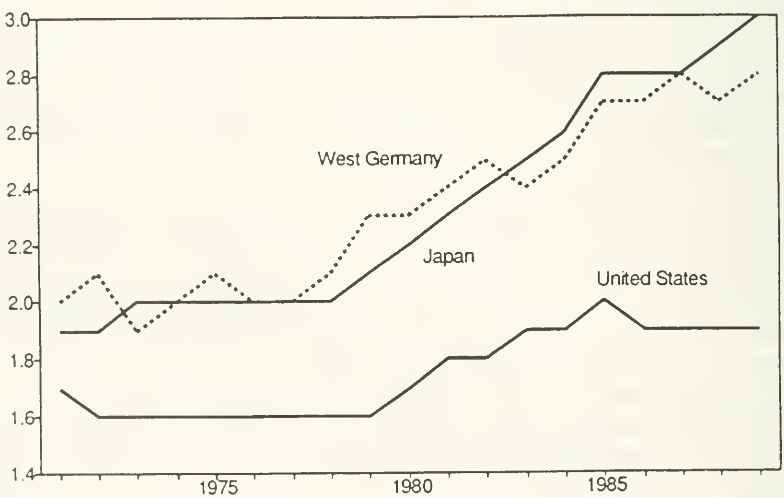
Representative Obey. Well, I certainly agree with that. Even if you forget a stimulus package, if you forget the tax preferences that are being given to small businesses, small business is where most of our growth occurs.

I think Senator Bennett pointed out in the first hearing that he attended as a Member of this Committee, when I talked about some of the problems that some of the larger companies had, he correctly pointed out that we rely on small business for most of the job growth in this country. That is why I was pleased to see some of the tax provisions which are focused on the side of business entities and have been providing the most growth.

We have a chart that demonstrates that our research budget in comparison to Japan and Germany has been much smaller as a percentage of our GDP for years, and that is something that you are trying to reverse, and which I think is crucial to economic growth. (See chart below.)

Nondefense Research and Development

Percent of GNP



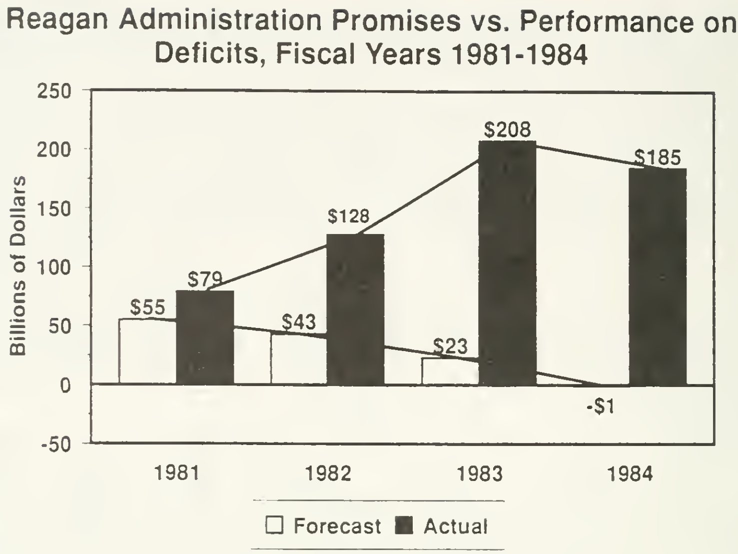
I have one more statement and then I will ask other Members for their questions. I really think what we need to recognize is that all these charts and all of the numbers that we have seen for years in the economy demonstrate that from 1945 to 1973, this economy was functioning pretty well, whether you look at it in terms of what brings down the debt, or whether you look at it in terms of family income—any way you want to slice it. But since 1973 we have been in trouble. And I think that what that demonstrates is that since Democrats and Republicans ran the government between 1973 and 1980, and you had Republican Presidents from 1980 on, we have had ample demonstration, certainly since 1973, neither party has had the answer. It seems to me that the question now is, are we going to be able to find the answer that will stimulate growth, and do it in a manner that is equitable to most American workers? What I don't want to see happening is a repeat of these promises.

I want to congratulate the President, even though there are several items that I wanted to see wacked. I wanted to see the Super Collider wacked, for instance. I would personally cut defense spending more than he has. But I congratulate him for not behaving as though he is the president of an optimist club by including all kinds of cuts that I might vote for, but which an honest assessment would indicate would not pass.

Whether or not we can get this deficit reduction—and I think we can get most of it—we need to know whether or not the President has made a realistic assumption about whether these cuts can be passed. A number of them came up under Reagan, and they were turned down.

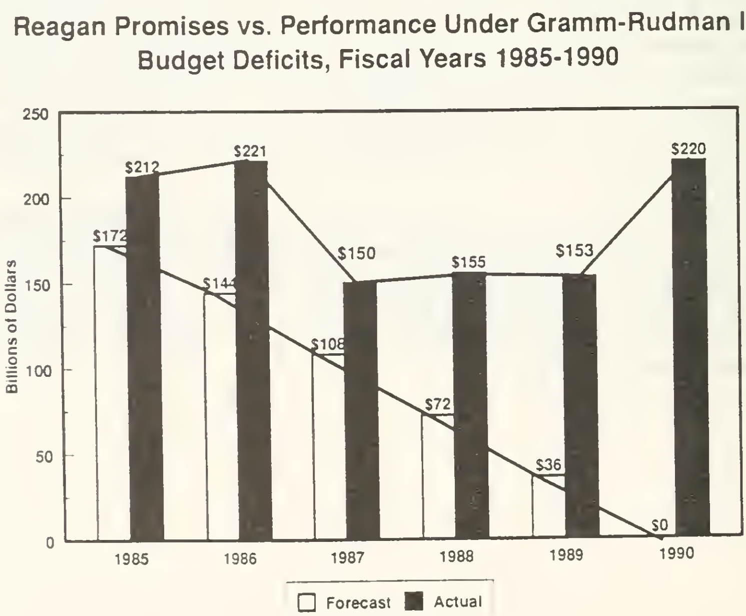
I would submit to you that a good number of the cuts that were turned down under Reagan will be passed under Clinton, because the context in which they are being sent down is the right context—the mix is better. You have an investment component rather than a shredding of the investment credit on the public side. You have a much fairer sharing of the burden of the cost of the package, and I think that will enable a lot of people in the Congress to support some of the cuts which, in the past, they had been reluctant to pass because they felt they were presented within the context of a very unfair package. I congratulate the President for that.

I get bugged about this ratio talk. We have had a lot of neat formulations in the past. We had the Reagan-Bush budget itself that said that we would take, as represented by these green lines, the deficit down from $55 billion to zero from 1980 to 1984. That line shows the promise. This shows what actually happened. We didn't get there. The deficit exploded. (See chart below.)



Source: Office of Management & Budget, Joint Economic Committee

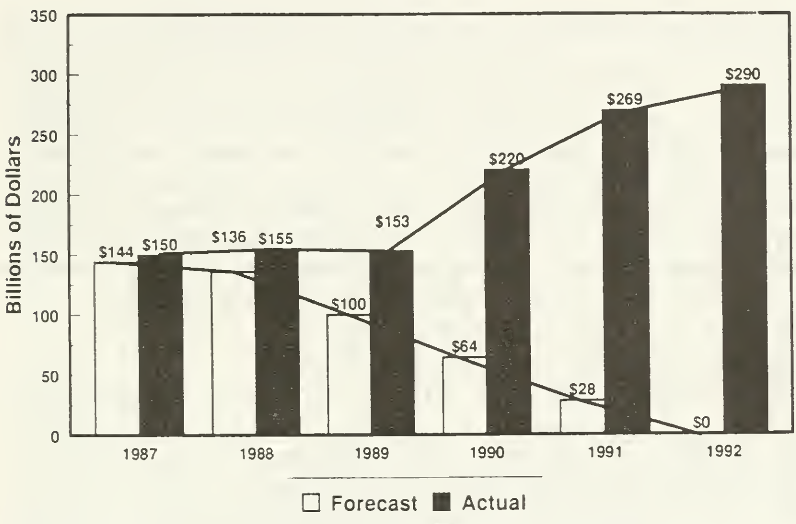
So, then, we had a nice magic formula. I sat through those meetings and we talked for hours about the different formulas and the balance. We finally got a nice, neat formula under Gramm-Rudman—the one to fix it. It was going to go from a $172 billion deficit down to zero in nice, neat $36 billion increments. It didn't happen. The red line shows what happened instead —$220 billion and counting after 1990. (See chart below.)



Source: Office of Management & Budget, Joint Economic Committee

Then we had another fix, all of them well-intentioned, voted for by Democrats and Republicans. Again, we had a nice, neat promise of five years with declining deficits. This is what happened. (See chart below.)

Reagan-Bush Promises vs. Performance Under Gramm-Rudman II
Budget Deficits, Fiscal Years 1987-1992



Source: Office of Management & Budget, Joint Economic Committee

I think this shows that you can design any system you want—I don't care if it is a Gramm-Rudman system or a balanced budget. I served in the legislature in Wisconsin, and we had a constitutional prohibition against debt. In the six years I served, the budgets that governors presented to us doubled our indebtedness. We made the lawyers rich—John Mitchell was one of them—but we didn't get the debt down much.

So I think that the beauty of this package is that it is going to be packaged in such a way that at the end, when reconciliation comes, we will know what the spending cuts are going to be, and the President will know whether the integrity of his package has been maintained. That is what is different this time. Because it will be wrapped into a single package, and we will know that the spending levels are being adhered to, as well as the revenue increases. I think that is the strength of the package, in addition to its realism, as I said, reserving the right to object to individual pieces which any of us will have, given the fact that we represent different parts of the country.

Dr. Tyson. One of the things that we did explicitly do, besides choosing very specific items to cut with a trajectory of cuts, the path of the deficit is not insensitive to the state of the economy. One of the problems has been to project out a deficit path on the assumption of what the economy will do, which has proven over and over again to be overly optimistic. So the actual path is different from your projections because you have forecast the economy to be stronger than it turns out to be.

Now, whether this was by intent or design—sometimes it was intentional, sometimes unintentional—we can't forecast perfectly—but we chose to set the task realistically by saying, assume a projection that can hardly be faulted as being overly optimistic or rosy. We have a deficit path that we are trying to hit, which we believe to be a realistic; indeed, possibly, a pessimistic scenario. That means we should do better. We don't want the American people to feel that after all this that we are going to come out again with a promise to do one thing and a reality of something else. We have set up our forecasts saying no gimmicks or rosy scenarios. Let's give a moderate-to-worst-case scenario and show you what we can do with that. There is a difference.

Representative Obey. Congressman Cox.

Representative Cox. Thank you, Mr. Chairman.

On the subject of gimmicks and rosy scenarios, is it something of a gimmick or a rosy scenario to propose the largest tax increase in American history and assume that it is not going to hurt the economy?

Dr. Tyson. It is my recollection from Secretary Bentsen, who has been at this game much longer than I, that this is not, in fact, the largest tax increase in American history; that the largest tax increase in American history, in real terms, was a 1983 TEFRA package. Secretary Bentsen will be coming forth with some evidence to suggest that, and that is his public statement.

Representative Cox. I would just interject that a great deal of this debate hinges on whether or not you count as tax increases things that are currently labeled as spending cuts.

I would add to the social security conversation that we had before, a footnote. In 1983, social security taxes and income taxes were scored as taxes and the outlays were scored as outlays. They were not scored any other way.

We have $1.3 billion in alleged spending cuts because the President has decided not to give everyone a raise next year. Only in Washington can this be called a spending cut. You are talking about spending the same amount of money next year as this year, and yet it is a $1.3 billion spending cut in the scoring. You are talking about auctioning off telecommunications spectrum and selling it; whereas, currently it is granted as a government monopoly, but you're calling it a spending cut. It is an intake of government revenues. I wonder whether or not we aren't engaged in rosy scenario budget manipulation here. These are real taxes that we are going to extract from the economy when we are

talking about social security, when we are talking about the rest of these extractions.

Dr. Tyson. We are currently giving away spectrum. If we all of a sudden have a user fee or an auction for spectrum, I don't see that as a tax.

Representative Cox. Is it a spending cut?

Dr. Tyson. Relative to what——

Representative Cox. It is revenue.

Dr. Tyson. I see it as a benefit that we were giving out, which we are not going to give out to the same extent.

Representative Cox. By the way, I support it. I think it is a wonderful idea, but I think it is misleading to score it that way.

Dr. Tyson. Let me say how one approaches this whole process. We didn't invent this procedure. I think the American people understand that the budgetary procedure is very involved. You look out and you forecast out whether government spending will be on, say, federal-employee pay, and you see that it is going to be a certain amount next year, a certain amount up to 1997. You then say, relative to that baseline of spending, we are going to make a cut. In fact, we are not going to spend as much on federal employee pay as is currently projected. That is a cut relative. If we do not introduce this policy, we will spend more next year.

Representative Cox. It is specifically a cut in our projection?

Dr. Tyson. No, it is a cut on what we are going to spend next year.

Representative Cox. We will spend next year only what we decide to spend next year. We do the budget on an annual basis.

Dr. Tyson. We are involved in trying to develop a long-run path to get the deficit down. The only way to do this is long run. If we tried to eliminate the deficit tomorrow, first, we would be unable to do it and, second, cause great harm to the American economy. If we want to have a long-run strategy, we have to make a series of projections—more than one year. We have been in cycles of budget agreements of five years. The only sensible way to do this is to project out what spending would be in the absence of a policy and then say how you change that spending with a policy projection that you make.

So I view that as understandable to the American people. We are saying here what we currently anticipate will be spent. Here is what our policy will do to that amount of spending.

Representative Cox. To use my colleague's analysis of the guy on Main Street, either in California or in Wisconsin, if you tell him the government is spending a hundred bucks this year and we are talking about spending a hundred bucks next year for the very same things, he is not going to consider that a spending cut. Only in Washington where you get to project spending of, say, \$110 next year and then cut it in your speeches, can you get to \$100 in spending as a cut.

Dr. Tyson. I think families would understand that completely. Families look out next year and the year after, and they see what they think they are going to be spending on a mortgage payment. If they then see that mortgage payments are likely to be lower next year, they see that as a cut in their mortgage spending.

Representative Cox. Lower, yes. Let's leave that alone. Let's talk about the energy tax for a moment.

Dr. Tyson. Can I say one other thing on this?

Representative Cox. The Chairman may or may not be liberal with the time.

I want to talk about the energy tax. I have a conceptual problem with it. If the tax reduces America's dependence on energy by reducing consumption, isn't lower consumption going to mean less revenue from the tax than the $71.4 billion that is presently projected? Have your revenue estimates taken into account reduced consumption?

Dr. Tyson. Yes. The revenue estimates take into account what the anticipated effects of the tax are on the economy and then adjust the revenue estimates accordingly. So they are done that way.

Representative Cox. With respect to the President's trip to Seattle, the Boeing plant is laying people off. United Airlines is canceling orders. In fact, the airlines collectively lost about $4 billion last year. Their single largest operating cost is jet fuel. They estimate the energy tax will cost $1.4 billion, perhaps more, in the first year that it is implemented. Isn't this backwards? Aren't we exacerbating the problems?

The President is making a speech and saying that we are sorry you are laying off all these people. Meanwhile, he wants to increase the operating costs of the industry, which is canceling its orders, by over a billion dollars, forcing Boeing to lay people off.

Dr. Tyson. I guess I would answer that by going back to the purpose of all this. If you take any item of this package in isolation, you can criticize it some way or another. The energy tax is not just because we want to have an energy tax. It is not because we would like to have higher prices of jet fuel. We would like to have lower prices of jet fuel. We would be better off. But you have to take it in context.

We have a package meant to get the economy, once and for all, away from a spend and spend fiscally irresponsible trajectory that it has been on in the past decade or more, to a sound trajectory where the government is not claiming so much of society's resources. Boeing will benefit, as other major American producers, small and large, will benefit, from having significantly lower interest costs in this society. Boeing will benefit, as will other producers, from having a more rapidly growing economy in this society.

The problem with American airline industries and with a number of other industries is the slow growth in the American economy. So you have to ask yourself, do you believe, as I believe, that the package will create these other benefits? If you do, they more than offset the prob-

lem caused by one particular component of it. So I think you have to ask yourself that question.

As an aside, let me say that although it is not on the table for discussion today, the President is extremely concerned and has voiced it in at least two public appearances about the problems of the U.S. aerospace complex, not just the airlines, but aircraft producers and the military and civilian side of aircraft producers. And we will be working very hard to try and develop a broad-based strategy to deal with the problems of that complex.

That is a separate issue from this, but I want to make sure that the President's commitment to this is absolutely clear because he brings it up again and again.

Representative Cox. I think you raise a sound point that we ought not look at the package one part at a time. As I see it, it is largely an enormous tax increase. I give one example with the airline industry and Boeing of how it might work there. Overall, I am concerned that if the big piece of this package is a tax increase, and if on the spending side the package itself contains $160 billion in new spending, then perhaps we aren't doing as good a job as we might of reducing the claim that government makes on the resources of the private economy, because instead we are extracting much more in the form of taxes and spending much more and making government that much larger.

That is why I used the point that you are claiming to cut spending by $1.3 billion, when, in fact, all you are doing is just not giving everyone a raise. You are not really doing the hard labor of getting after the spending parts of government that don't work and eliminating them.

To harken back to what my colleague from Wisconsin said, I think you are right. The man on the street probably doesn't care what the ratio of spending cuts to tax cuts is. They want results.

Likewise, they probably don't want to hear us say that we are going to give you a $250 billion deficit in fiscal year 1998—that is what this plan is projecting. They probably don't want us to say, "Go ahead, increase spending, increase taxes, leave the deficit at $250 billion in fiscal year 1998 as long as you can tell us that you are going to reduce the deficit as a percentage of GDP in the out years." They don't say that to me on the street corner either.

Dr. Tyson. On the government spending side, there are two things to note here. One is that, as I indicated in a question from Congressman Obey, this package is going to generate growth for the economy. The lion's share of that growth—96 percent—goes to the private sector. Government in this tax package is going to claim about 4 percent of that growth.

Let me say something else. If you look at the trend of government spending relative to GDP and look at what happened over the 1980s through 1992, if you don't correct for cyclical differences—like when the economy is slow— the government spends more on certain programs like food stamps and Medicaid and unemployment compensa-

tion, and when the economy picks up, it spends less. If you look at government spending to GDP ratio over the 1980s, it didn't go down. Actually, it went up. If you look at what we project, we project a decline in government spending relative to GDP. This would be a real reversal. If we get this package through——

Representative Cox. If I might interject here, am I right that you do that not by showing a reduction in the amount the government spends, but by an increase in the denominator; that is, the assumed future size of the GDP?

Dr. Tyson. What is the question here? The American people, I assume, understand that, that the size of government and the American economy is at issue. I am saying, if you take this package and project out, the size of government and the American economy will begin to come down. That is true. That is different from the period we just went through. That didn't happen. For people who think that happened, if you look at the numbers, that didn't happen.

Representative Cox. I certainly agree that it did not happen.

Dr. Tyson. This is actually reversing.

Representative Cox. There is no question that you have an enormous deficit now precisely because government spending was increasing.

Dr. Tyson. It was increasing as fast or faster. What happened in the 1980s——

Representative Cox. Tax revenues during the 1980s more than doubled. The spending increased so much faster that we have a larger and larger deficit.

Dr. Tyson. As a percentage of GDP, government spending was either constant or cyclically correct. It went up a little bit. As a percentage of GDP, taxes were constant. So, actually, what happened is that we didn't get any downward trend. When you go back to the beginning of the discussion about the 1980s the notion was that we will cut taxes, cut the size of the government in the economy by cutting taxes and spending in the economy. As a percent of GDP, taxes did not, in fact, fall, and government spending relative to the size of the economy went up somewhat. That is how we got the debt problem.

Representative Cox. That is to say that the rate of growth in spending exceeded the rate of growth in taxes?

Dr. Tyson. The rate of growth of spending exceeded the rate of growth of taxes; right. That is true. I am saying what is dramatically different about this is that government spending as a percentage of GDP, the size of the government in the economy, if you follow this package, comes down.

Representative Cox. There is one key assumption in your contention, that we know what the future size of the economy will be as measured by GDP. We have to assume that growth. So increased government spending is nonetheless relevant.

Dr. Tyson. That is correct.

REPRESENTATIVE COX. My concern is that the economy might not respond the way we want it to when you raise taxes by this magnitude.

I wonder if I could follow up on this energy tax. You said that CEA or the Administration has taken into account the negative effects of the tax in your estimates on revenues and consumption. Now, most of the cost of energy throughout the economy is felt in the production of goods and services. In fact, it is estimated that this total cost is four to five times what all households pay for their energy bills straight up. What do your estimates show for the cost of goods and services as a result of this higher tax?

DR. TYSON. The estimates I was talking about, the Treasury estimates, are estimates that look at the effects on collecting a wide variety of tax revenues. Any particular tax will affect large amounts of behavior, and they try to build those into the model and come up with a net revenue estimate once those behavioral adjustments are in the picture.

As far as the overall effect on prices, go back to the way I answered your first question, look at the overall effect of the entire package on price projections as well as on GDP projections. Essentially, what happens is that we have projected, on the basis of running models with the overall package, that we get a higher rate of growth of GDP than the baseline forecast—the CBO forecast—that we get to capacity utilization more quickly, that is, we get the trajectory of lower unemployment rates up and get to our full employment level more quickly, and we do that without any significant upward trend in inflation.

We project that the inflation rate in the economy goes from 2.8—this is a Consumer Price Index in 1993—to 3.5 in 1998. Actually, this is the DRI forecast. We have done one similarly, and we project as a whole package that there is no reason to anticipate any significant upward trend in inflation. We didn't look at it piece by piece. We looked at it as a package.

Let me say why you would do it that way. While it is true that an energy tax raises energy prices by a range of 3 percent depending upon which energy and that, in turn, there would be price effects throughout the rest of the economy, it is also true that lower real interest rates have a profound effect on costs throughout the economy. So we built both of those factors and a number of other things into the model, and came up with projections that basically say that the economy will grow more quickly, with no noticeable increase in inflation as a result of this package in its entirety.

I would be happy to share with you a calculation that just looks at the effect of any particular item, but I don't think that is the appropriate way to judge the package.

REPRESENTATIVE COX. If I understand your number, you are expecting a change in inflation from 2.8 percent to 3.5 percent?

DR. TYSON. That was the DRI. The one I gave you was a DRI forecast. Compare a DRI forecast—an independent, private analyst forecast—through 1988 with ours. We ran the whole package. Ours goes

from an inflation rate of 3 percent in 1993 to an inflation rate of 3.4 percent in 1998.

It is widely viewed in the private forecasting community-and I don't think our forecast is far off from that-that for a variety of reasons having to do with the underlying-where we are relative to our capacity in the economy, where we are in terms of rate of growth of labor compensation—it is hard to predict, even with an energy tax, any significant change in the inflation scenario over the next four years.

Representative Cox. Apart from the effects on inflation, has CEA or Treasury or the Administration tried to get its arms around the changes in prices of goods and services as a consequence of the energy tax? I mentioned over a billion dollars in one industry for jet fuel. Anything like an attempt to aggregate all of those cost increases and figure out how much more.

Dr. Tyson. I am sure that that has been done. I don't have the numbers here. I would be happy to share them with you. Those numbers are only interesting as a kind of partial analysis, because what you really want to know is how the overall price level moves over time as a result of the overall package. So if you do that analysis, which can be done, and I believe the Treasury has done, you will see a price effect that comes simply from the energy tax.

There is no way to deny the notion that the energy tax will affect the price of energy and will affect the price of things that use energy. One doesn't know how much because it depends on how much businesses pass through the cost increase into a price increase, and it depends upon how consumers and users of energy and users of products that embody energy respond to higher prices.

One can do that analysis, and I am sure it has been done and I will share it with you. I want to emphasize that it is only a partial equilibrium analysis. Nobody wants this energy tax in isolation. It is proposed as part of a very big package designed to do a number of things. Our forecast and private forecasters do not think that when we put all those things together, there will be any noticeable difference in the trajectory of the American price level measured by rate of inflation over the next four years. The price level effect is a wash. It disappears because you are doing other things to reduce the price level so that the rate of inflation is invariant relative to this package.

Representative Cox. As a handle on this, I take it that your $71.4 billion revenue projection from this tax is a shortcut to guessing how much it is going to take out of the economy.

Dr. Tyson. It is not a shortcut. The Treasury——

Representative Cox. So at least that much will be the measure of the cost of increases.

Dr. Tyson. The Treasury estimators have a very sophisticated methodology, which I could not and would pretend I could describe to you. For any adjustment in revenues, whether up or down, because of the models they have and historical behavior that they use, they have a way

of predicting how a particular revenue item will affect the behavior of users or producers, and of how prices are formed; and those are all embodied in that calculation. So that is a realistic calculation relative to what the Treasury's models and experience with revenue changes in this economy predict. It is a realistic measure.

Representative Cox. Thank you.

Representative Obey. We have been discussing an awful lot of numbers. The fact is, any way you slice them, the numbers tell us something about historical trends. I would submit that what happens in any one year doesn't mean beanbag in terms of the overall strength of the economy. What means something is that when over time, if you take a look at the problem we are trying to correct, that problem can be summarized in a number of ways.

In 1945, our debt was over 100 percent of our annual national income. It dropped down in 1973 to about 23 percent of our annual national income. It was stalled from 1973 to 1980, and under the policies of the last 10 years, it has doubled from 23 percent of our annual national income to 50 percent, if you want to look at raw deficit numbers.

The picture is pretty clear. This blue line represents B.C. and A.D. in economic terms; it is before Reagan, after Reagan. Before Reagan, there had never been a deficit larger than $74 billion. We can see what has happened to it today; whether you count it as a percentage of GDP, whether you count it in raw numbers of terms, adjusted for inflation, there ain't no doubt that it is larger today than it was yesterday. No doubt.

Much is made of the tax increases in this package. I would submit the issue is not the ratio between taxes or anything else. The question is, who pays for the taxes that are being asked? And I think the answer is, the folks who ought to pay are the folks who didn't in the 1980s.

If you take a look at this chart, it demonstrates clearly that in terms of change in share of national income, from 1980 through the decade, the only folks who cleaned up were the top 1 percent. Now, if you add to that another 4 percent, so you have the top 5 percent in total, they are the only people who had any appreciable growth in income over the 1980s, unless you are going to start counting pennies. And that is who is being asked to bear the lion's share of the tax increases in this package.

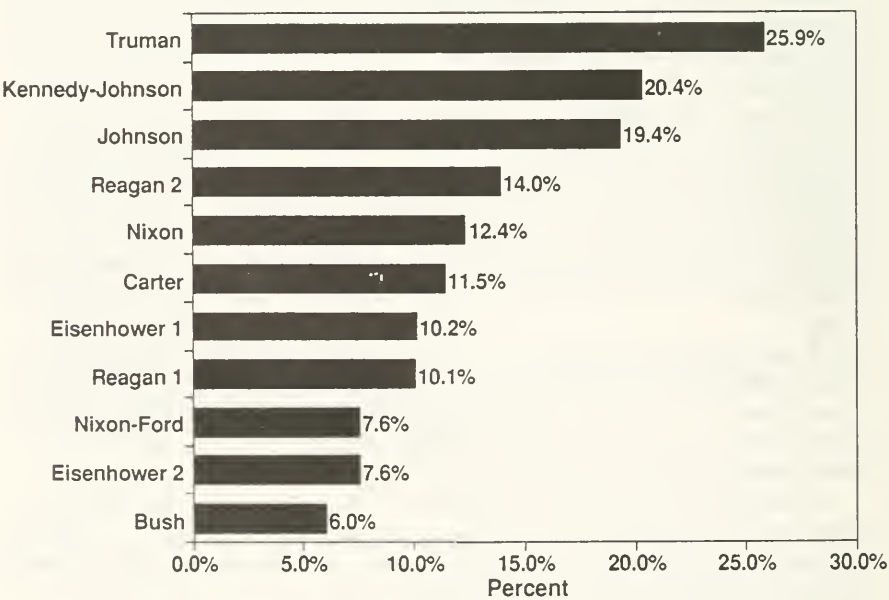
I don't think the American public is going to be too unhappy with that distribution in comparison to the distribution tables. If you want to see what the distribution tables were for the Reagan-Bush budget, all you have to do is look at the 1980s. That shows the distribution table—not pretty for the average middle-income person.

I would say, you betcha, spending in the 1980s went up faster as a percentage of GDP than revenues did, primarily because of defense, health care and interest. Reagan said that you could double the military budget and pay for it with a free lunch.

We have had a consistent refusal to attack health-care costs by the Congress and the President. I can remember under Carter when I was supporting his initial efforts at hospital-cost containment, supporting and watching it get blown away by the special interest groups.

The President's budget tries to attack both of those. The defense budget is going down. The growth in health-care costs is going to be squeezed very tightly if the President has his way, and I guess I would just say that we have tried it the other way. Not only have we had a tremendous upward movement of huge amounts of dollars in terms of income, we have also seen what has happened to the economy as a rest. Because if you take economic growth and arrange it by every President's four-year term, as this chart does (see chart below)—it arranges economic growth under every President in descending order of growth—that means, under Truman, we had a 25 percent growth in the economy during his four-year term. That obviously was a special case because it was the end of World War II and had all the pent-up consumer demand. The next best performance was Kennedy's term, which Johnson filled out after the assassination: 20 percent economic growth during that four-year term. Then Johnson's second term, then Reagan's second term, sliding down to the previous low of 7 percent economic growth over Eisenhower's second term. Then you finally get down to the last four years, dragging up the tail, in the caboose.

Economic Growth by Presidential Term
Increase in Real GDP



If you take a look at employment growth during the same period, again arranged since the end of World War II in descending order of job growth, starting with the four-year term that produced the biggest increase in number of jobs—Carter's term—11 percent increase; Reagan's second term, 9.8 percent. Then sliding down to the first two rows, Eisenhower's first and second terms, 3 percent in job growth; then you get down to the last four years, only 1 percent job growth. If you take out public-sector job growth, you have no job growth at all.

We can argue these numbers any way we want. We can say the world is round or we can say it is flat, any way we want, but in the end what counts is, will the package work? Is it fair? That is about all that counts.

To summarize why I think the President is on the right track, I am not going to quote the left-wing liberal pinko economists; I am going to quote the chief political analyst for the 1968 presidential campaign, Kevin Phillips. Archie the Cockroach is my favorite philosopher when it comes to human nature, but when it comes to political and economic history, Kevin Phillips is my favorite. He said:

> Even as the middle class was shrinking, the top 1 percent economy marshaled its own well-funded intellectual champions, ever ready to contend that critical studies and statistics were wrong, that America's true weakness lay in eroded family values or the pernicious politics of envy, or to argue that the rich hadn't really done that well, or if they had, it made no difference because the ranks of the rich were always changing.

Some of these champions are in Congress, but many hung their hats in conservative foundations—the Heritage Foundation, the Hudson Institute, the American Enterprise Institute, the Manhattan Institute, as well as other lesser centers. The aim of this book, which he just wrote, by contrast, is to focus on the factors and predicaments that many defenders of the status quo have tried to sidestep-middle-class decline as a national danger signal, rising economic polarization, the irony of tax rates—as Secretary Bentsen pointed out yesterday—that hit record highs for average families and record lows for millionaires, the inadequacy and even misrepresentation of government statistics, and the citizenry's worries over endangered pensions, home values, future living standards, deteriorating public services, and the rapidly increasing cost of private services, including health care.

I really think that he sums up what is bugging the average person in this country.

So when you cut through all the political debates about numbers, the only thing that matters is, will this work? Is it fair? Can it pass? If it passes all three tests, the country is going to be better off. If it doesn't, it won't.

So I submit, as I said earlier, that what counts is not, does this package cost somebody something, no matter what income group you are in. What counts is whether the cost of this package is less or more than the cost of continuing down the status quo road. That is the real test.

It isn't an assessment of this package standing alone. It is a comparison of this package to what. To me, if you look at it that way, so far it is the only play on the board, the only card on the table, and in contrast to previous budgets, which were so outrageously optimistic that they were dead on arrival, because people in the President's own party were laughing at them so hard that they couldn't stand up straight.

The public understands, I think, and I think most and Members of Congress understand that this one, on average, is roughly a whole lot more honest, a whole lot more realistic; and we will see how much of it survives over the next few months. I suspect a good piece of it will.

Thank you very much.

Representative Cox. I wonder if I might, just in closing, make an observation, because Senator Robb had some interesting concerns that are not often enough expressed by Congress at all. The fact is that there are people who do want to see more spending cuts. I would include myself among them. Yet, institutionally, it is a real question, based on history, of whether Congress is ever going to lead the way to spending cuts.

So, when Leon Panetta went before the Budget Committee, and you, Dr. Tyson, have come before the Joint Economic Committee today, and each says, "we would be delighted to work with Congress if you will make specific proposals to cut spending, but here is the best that we can do," I think we are losing an opportunity for leadership. The President has the opportunity when he goes abroad to St. Louis and Seattle and California to say, "I am going to force the Congress, if not to see the light, then to feel the heat. Here are the spending cuts I am proposing; I am going to terminate federal agencies that don't work any more."

President Reagan used to say that he couldn't figure out how many government agencies there were. As far as I can tell, there isn't a single government agency eliminated in this program. We have to make the tough choices, but the President has to lead the way and force Congress to act because 535 people up here, with the exception of people like Senator Robb, aren't ever going to get up to the task.

Representative Obey. I would say that the President has already demonstrated that leadership. If he can get the spending cuts through that he has already submitted, he will have done more to trim unnecessary spending than any President since I have been in this Congress for the last 24 years.

Dr. Tyson. I think that you have to look at these spending cuts also as part of the picture, because we know that the biggest increases in spending now are coming really in interest and in health. So part of what we are going to have to do is to continue to work on this through the health-care issue as well.

I think that the President has shown a lot of leadership in choosing a lot of cuts that have been up before and not gotten through and choosing new ones to get through.

As one person just joining the government, I can assure you that we are all absolutely committed to work as hard as we can to scale down the cost of government, and that really means to scale down—to scale down superfluous computers, or to scale down limousine services, or to scale down bonuses to outgoing workers. We want to try and gain efficiency in government because government, like the rest of society, is going to have to contribute to a solution to this problem once and for all.

I think the President really means it when he says he will be happy to work with people thinking about additional cuts, but we have been very bold in laying out one agenda, which is a good starting point.

Representative Obey. Doctor, thank you for working with this committee again.

Dr. Tyson. Thank you. I look forward to future sessions.

[Whereupon, at 12:45 p.m., the Committee adjourned, subject to the call of the Chair.]

SUBMISSIONS FOR THE RECORD

WRITTEN OPENING STATEMENT OF REPRESENTATIVE RAMSTAD

I am pleased to have the opportunity this morning to discuss President Clinton's economic proposal with Dr. Tyson.

I applaud the emphasis the President placed in his well-delivered speech on reducing the massive budget deficit. But in looking at the substance of the plan, I am gravely concerned by the ratio—which varies according to which analysis you read—of tax hikes to spending cut.

Whichever analysis you use, the plan clearly does not meet the Administration's own stated goal of two dollars in spending cuts for every dollar in new taxes.

With all respect, I believe we must reduce the suffocating deficit primarily by cutting spending.

I had been hopeful the President's plan would recognize that the private sector—and not the government—creates jobs. Instead, his economic proposal and the testimony of his advisors before various congressional committees indicate that he believes raising taxes will damage the economy less than reducing spending.

Asked why the five-year plan does not include significant spending cuts in the early years and tax increases later, OMB Director Panetta responded that spending cuts would "cause even greater consternation with regards to the economy."

I would submit that taking funds out of the pockets of the productive, private sector will be far more harmful to the economy than forcing a bloated government bureaucracy to tighten its belt. I do not believe Congress has a right to ask the American people—particularly middle-income taxpayers—who have seen congressionally-mandated spending programs consumer larger and larger portions of their "contribution" to the federal government every April 15—to give even more to a wasteful and profligate bureaucracy.

I believe the American people are willing to sacrifice to confront the deficit problem. But we cannot ask them to this if the federal government does not first seek to cut its own spending.

I have received hundreds of calls from my constituents over the last week reacting to the President's proposal. Many have urged me to avoid "partisan bickering" and work with the President to eliminate the enormous federal budget deficit. I would like nothing more than to work with the President and his advisors to attack this grave problem that threatens the long-term viability of our economy.

At the President's request in the State of the Union address, I submitted my suggestions for additional spending reductions the morning after the speech. I hope they will be considered very seriously. I also hope the President takes very seriously the legitimate concerns that many have expressed about the heavy emphasis on new and higher taxes in his plan.

Thanks again for coming this morning. I look forward to this exchange, during which I hope we can focus on the economic effects of the substance of the plan and the President's decision to rely more on tax increases than spending cuts to attack the budget deficit.

PREPARED STATEMENT OF THE HONORABLE DR. TYSON

Thank you, Mr. Chairman, for the opportunity to testify before the Joint Economic Committee.

The election of 1992 was a clear mandate for change—in particular, economic change. No wonder voters expressed this preference. A number of disturbing economic trends have developed in recent years. Let me name just a few of them: median family real income has been stagnant—its 1991 level was actually below the level reached in 1979—despite more two-earner families; the poverty rate in 1991 was higher than in any year during the 1970s; a growing gap between the rich and the poor; a Federal Government that is borrowing to pay almost a quarter of its current bills; and escalating health care costs that are burdening firms and workers as never before. It is little wonder that the voters gave a mandate for economic change.

Underlying these disturbing trends are three fundamental problems in the American economy: a recovery so anemic it has been unable to support substantial employment growth; an erosion in the growth rate of productivity over the past twenty years; and an increase in inequality that has undermined the sense of fairness in our economic system.

The President's economic package—consisting of a short-term stimulus, an investment program, and a deficit reduction plan—is designed to correct each of these fundamental problems. The short-term stimulus is intended to ensure a sustained economic recovery that is strong enough to generate employment growth. The investment and deficit reduction components of the package are directed toward boosting productivity growth and living standards over the long-term. All elements of the package are designed with an eye toward restoring basic fairness to the system. Let me elaborate on the President's plan in the context of our fundamental problems.

Economic Stimulus

The United States economy has experienced a protracted period of poor performance. Since 1989, the average annual rate of GDP growth has barely exceeded one-half of one percent—inadequate to keep up with population growth. This period was marked first by sluggish growth in 1989 and early 1990, then a recession which lasted from July of 1990 until March of 1991, and finally a very slow recovery since March of 1991. The recovery has been so slow that most Americans barely noticed it was underway. In the third quarter of the recovery, the economy showed serious signs of falling back into recession—real GDP grew by only 0.6 percent and real gross domestic purchases actually declined. Only 500,000 jobs have been created in the 22 months of recovery—this is about 3 million fewer jobs than would have been created in the first 22 months of a typical economic recovery. Not surprisingly, the unemployment rate is still higher than it was at the bottom of the recession. Although there has been a recent stream of good economic news, signs of weakness and cause for concern about the recovery remain.

Many of the factors that contributed to recession or sluggish growth over the past four years are still acting to depress the economy. Many U.S. companies are in the midst of a painful restructuring process that will ultimately make them more competitive, but currently generates large permanent layoffs. This restructuring is manifest by the fact that the fraction of unemployed workers that have permanently lost their previous jobs reached an all-time high of over 45 percent in October of 1992. Ongoing and future reductions in defense spending will require a significant reallocation of resources that will continue to act as a drag on the economy. This process actually began in the late 1980s,

and before it is completed may well involve a shift of over 3 percent of our GDP from military to civilian purposes. In several parts of the country the commercial real estate market remains considerably depressed, a consequence of overbuilding that occurred in the 1980s. There is little hope that commercial real estate construction will return to 1980s levels anytime soon. Also, a number of our trading partners are experiencing much slower growth in recent months and that reduces growth in our exports. Real GDP in both Germany and Japan, for example, declined in recent quarters. Furthermore, reduced withholding of taxes last year will reduce tax refunds this spring, which is likely to make consumer spending unseasonably low. For all of these reasons we cannot be overconfident about the continued strength of the recovery.

Given the fact that the recovery has stalled in the past, gains in employment during the recovery have been small to date, and many forces will continue to exert downward pressure on the economy, President Clinton's economic plan includes a stimulus package of spending increases and targeted tax cuts to spur investment and job growth in the near term. The short-term stimulus package is best viewed as an insurance policy designed to make sure that recovery does not falter again, and as a downpayment on the investment plan that will largely occur in subsequent fiscal years.

Three criteria have guided the design of this package: the potential for rapid spend-out rates; consistency with the investment program; and modest size. All of the items included in the package are fast-acting and job-creating. The unemployed have already waited far too long. All of the items included in the package are worthwhile on their own merits and are consistent with the basic long-run goal of shifting public expenditure toward investment. In that sense the package can be appropriately thought of as a downpayment on the Administration's overall long-run investment program. The size of the stimulus was limited by the deficit problem we have inherited—a problem that turned out to be much larger than we had been told—and by the fact that economic growth has picked up in the last two quarters. The modest size also reflects a desire to avoid overstimulating the economy in the event that the current recovery does continue at the pace of the last two quarters.

Our economic stimulus program comes to about $30 billion, composed of roughly 50% spending increases and 50% tax incentives. The spending side of the package includes increased funding for the following programs: extended unemployment benefits, highway construction, a summer jobs and training program for underprivileged youth, community development block grants, education programs, wastewater cleanup, and important environmental and technology programs. All of these programs are consistent with the philosophy of investing more in our people and our infrastructure.

The tax incentives are mostly in the form of investment tax credit programs for large and small businesses. The investment tax credit is incremental and temporary for large businesses (over $5 million in gross receipts). The basic rate is 7% (smaller for shorter-lived assets) on all equipment investment above 70% of a historical base (a three-year average) in 1993 and 80% of that same base in 1994. The credit applies to equipment put in place between December 3, 1992 and December 31, 1994. Small businesses, which would presumably find the recordkeeping of an incremental ITC burdensome, are given a 7% ITC from the first dollar for two years, dropping down to a permanent 5% ITC thereafter.

The Administration estimates that the stimulus package, taken by itself, will add about 0.3% to the annual growth rates of real GDP in 1993 and 1994, creating about 500,000 additional jobs by the end of 1994.

The Nation's Long-Term Problems

Sustainable increases in the Nation's standard of living can only be attained through rising levels of productivity. As the amount of output per worker increases over time, so does the potential consumption per worker. Because of this linkage, the rate of productivity growth is a crucial indicator of how living standards are changing over time.

From the end of World War II until 1973, productivity grew at an annual rate of about 2.5%, which implies a doubling in the standard of living in just under 30 years. The notion that each generation could leave its children a better place and a higher living standard was virtually taken for granted. Not any more. Since 1973, the average annual rate of productivity growth has fallen to about 0.8 percent, which implies that living standards will double every 90 years (down from 103 after adding 1992's high rate of productivity growth). The slowdown may be exaggerated to some extent by our inability to measure productivity growth in the rapidly growing service sector of the economy, as some observers claim, but a substantial portion of this slowdown is a consequence of adverse economic events and policy choices that promoted consumption rather than investment.

Intuitively, our productivity increases with improvements in technology or the skill of our work force and with increases in the amount of plant, equipment, and infrastructure our workers use in the production process. All of these driving forces of productivity growth require that we make investments—investments in research and development to improve technology; investments in health, education, and training to improve workers skills; and investments in buildings, machines, roads, bridges, railways, airports and the like to increase our Nation's capital stock.

The amount of investment that the Nation achieves depends directly and indirectly on government actions. Many government programs contribute directly to the stock of public capital—health care, education, training, and infrastructure spending, for example. Other government policies, especially tax policies, indirectly influence the amount of spending on private capital—research and development, plant, and equipment—that firms choose to undertake.

Policies of the last twelve years have eroded productivity growth in the economy by undermining both public and private human and physical capital formation. Conventional measures of public investment as a share of GDP have fallen each decade since the 1960s. Furthermore, the large budget deficits required to finance growth in defense and other non-investment government spending programs during the 1980s have reduced the pool of resources available for private investments in human and physical capital. We must reverse the fiscal policies of the last twelve years in order to increase capital formation and the rate of growth in our living standards. The investment program and the deficit reduction plan are intended to accomplish such a policy reversal.

The Investment Program

The investment program includes a wide range of items that have benefits that will be felt over long periods of time, and thus, fit the conceptual definition of investment. The Clinton investment package delivers on all of the major public investment initiatives promised by the President during his campaign—initiatives to put people back to work; initiatives to facilitate lifelong learning from childhood through retirement; initiatives to reward work for those who work hard and play by the rules; initiatives to address urgent public

health problems; and initiatives to encourage private-sector investments that provide technological gains and improved productivity.

The investment program totals $160 billion over four years, which redeems most of the President's campaign promises under the following headings:

REBUILD AMERICA: $48 billion over four years concentrated in six key areas:

- Transportation infrastructure ($8.4 billion), which includes full funding of the Intermodal Surface Transportation Efficiency Act and investments in mass transit, high speed rail, and airports.
- Technology ($17.0 billion), which will fund the National Science Foundation, science, engineering, and technology grants, high performance computing, and extension of the research and development tax credit.
- Environment ($8.0 billion), which will fund water cleanup, environmental technology, weatherization grants, forestry research, and natural resource protection.
- Energy ($3.0 billion), for energy conservation and renewable energy programs, fusion research, and more energy efficient Federal buildings.
- Housing and Community Development (9.6 billion), for Community Block Grants, fifty enterprise zones, assisted housing, and extension of the low-income housing tax credit.
- Rural Development ($1.5 billion), for priorities such as rural water and waste loans and grants and community and business development for rural areas.

LIFELONG LEARNING: $38 billion over four years for education and training of people from early childhood through adulthood. This includes some measures intended for defense conversion:

- A National Service program ($3.0 billion).
- Full funding for WIC ($1 billion).
- Full Funding for Head Start by 1999 ($3.7 billion).
- Education reform and initiatives ($3.2 billion).
- Worker training programs ($4.1 billion).
- Youth apprenticeship programs ($0.5 billion).
- Parenting and Family Support ($0.5 billion).

REWARDING WORK: $25 billion over four years, mainly accounted for by a dramatic increase in the Earned Income Tax Credit (EITC). The EITC is simplified and greatly liberalized. It is extended for the first time to workers without children—at a 7.65% rate that offsets the employee portion of FICA taxes. And the credit for workers with children is enriched enough so that a family of four with a parent working full-time at the minimum wage is lifted up to the poverty line. This category also includes emergency unemployment compensation benefits and a crime initiative.

HEALTH CARE: $26 billion over four years for AIDs, women's health, drug and substance abuse prevention and treatment, nutrition assistance, USDA food safety initiative, VA medical care, and improvements in Social Security disability insurance processing.

TAX INCENTIVES: $24 billion over four years to encourage private investment through investment tax credits, alternative minimum tax relief for corporations, targeted capital gains relief for small start-up businesses, and real estate investment incentives.

This program will stimulate private and public investment in order to increase our rate of growth in productivity and, ultimately, living standards. These new investments are a central part of the President's plan.

The Deficit Reduction Plan

Finally, in order to reduce government demands on credit markets, the President's economic package includes a credible deficit-reduction plan. The intent of deficit reduction is as a means to greater capital formation, productivity growth and living standards, not as an end in itself. Deficits require government borrowing—either from the private sector, reducing funds available to private investors and consumers and raising their cost of borrowing, or from the rest of the world, so that in the future a growing share of our tax dollars will be used to pay off foreigners who lent us money.

The President's proposal features a four-year (FY94-FY97) gross deficit-reduction program that is phased in gradually. By FY97 the plan will cut nearly $200 billion from the deficit, with $112 billion in spending cuts (this scores the increased taxation of social security benefits as an entitlement cut) and $83 billion in revenue increases. After allowing for the $55 billion in new investment initiatives that will be introduced as part of the investment package, the program achieves a net deficit reduction of $140 billion from the baseline deficit in FY97 alone.

The budget has no plugs, caps, gimmicks, or magic asterisks. All cuts are identified in the OMB document "A Vision of Change for America." The 150 specific spending cuts reduce Federal government spending by $247 billion over 4 years (this counts $7 billion of increased taxation of social security benefits as a cut in entitlement spending, rather than a tax increase). The spending cuts are nearly matched in magnitude by specific revenue increases.

The spending savings in the President's plan are in six general categories: programs that don't work or are no longer needed; eliminating subsidies for wasteful programs and charging fees for government services; managing government for cost-effectiveness and results; controlling health care costs; adjusting defense spending to new post-Cold War realities; and asking for shared contribution from all Americans.

Some of the larger items in the long list of spending cuts are:

- Defense spending reductions of $37 billion in FY97 and $76 billion over a 4-year period.
- Reduction of federal pay, retirement benefits, the number of civilian employees, and administrative budgets of departments agencies for a total savings of $11.7 billion in FY97.
- Higher taxation of social security benefits for taxpayers above $32,000 (joint) or $25,000 single: $6.9 billion in FY97.
- Shorten average maturity structure of the national debt: $3.9 billion in savings in FY97.
- Savings in Medicare and Medicaid (the sum of 33 programmatic changes, virtually all of which cut provider reimbursements); $17.7 billion in FY97.
- Auctioning part of the Federal Communications Commission spectrum: $2.1 billion in FY97.

The additional revenues raised in the President's plan are attained primarily by increasing taxes on the very wealthy, who have benefited most from the reduced taxes of the 1980s. This burden sharing is also consistent with the President's desire to reduce the growing gap between rich and poor.

Personal income tax rates are raised for approximately 1.2% of returns with the highest taxable income as follows:

- A 36% bracket begins at $140,000 for joint filers ($115,000 for singles).
- A 39.6% bracket begins at $250,000, regardless of filing status.
- The maximum tax rate on capital gains remains 28%, as under current law.
- The Alternative Minimum Tax (AMT) becomes two-tiered: 26% up to $175,000 of AMT income and 28% thereafter.

All these rate changes are estimated to raise $26.3 billion in FY97.

In order to raise revenue, encourage the conservation of energy, and reduce harmful emissions, the President's plan also includes an energy tax that is phased in gradually. When fully effective, the proposed new energy tax will be 25.7 cents per million BTU, with an additional 34.2 cents per million BTU on oil. These amounts are indexed, so that the tax rises slightly with the rate of inflation. The tax is phased in in three stages: one-third in July 1994, one-third in July 1995, and the final one-third in July 1996. Estimated impacts on retail energy prices are 3-8%, depending on the specific product. But the tax will be levied and collected at the source (production or import).

A higher tax rate is placed on oil for two reasons. One is as a national security surcharge. A hidden cost of dependence on foreign oil sources is the additional money that must be spent on foreign aid and national defense in order to protect our strategic interests. This surcharge makes consumers of oil bear part of that burden more explicitly. The second reason for the higher rate on oil is that a straight BTU tax would burden natural gas (a less polluting source) more heavily than oil (a more polluting source). In order to discourage consumers from substituting to the more polluting source as a result of the tax change, an additional levy on oil was required. Hence the oil supplement corrects two negative "externalities" associated with oil consumption.

The BTU tax is estimated to raise $22.3 billion in FY97, after netting out roughly $7 billion in reduced income and payroll tax receipts that Treasury revenue estimators assume will result from the tax. In addition, the Administration proposes additions to Food Stamps, the EITC, and the Low Income Home Energy Assistance Program (LIHEAP) to offset the burden of the energy tax for low and moderate income households. These additional programs cost roughly $10 billion, and ensure that families with incomes below $30,000 will face virtually no net tax increase.

The basic corporate tax rate is raised from 34% to 36%. In addition, a number of tax preferences and deductions are reduced or eliminated and tax enforcement is increased. Total revenue accruing to the government from these sources is estimated to be $14.1 billion in FY97. In addition, a variety of other changes in "business taxes" (which can appear on either personal or corporate returns) nets $8.4 billion in 1997.

The health insurance portion of the payroll tax will apply to all earnings, rather than being capped (as at present) at $135,000. The revenue yield from this change in FY97 is projected to be $6.8 billion.

A brief rundown of the key features of the President's deficit reduction plan verifies that these spending cuts and revenue increases are real and identifiable. But the budget game is a complicated one, and this is only the first step we have taken to make the package credible.

To allay any fears of "rosy scenarios," the budget projections are based on a highly unusual procedure: We use the pessimistic forecast of the CBO, rather than the Administration's more optimistic forecast—even though the latter

virtually matches the current Blue Chip consensus (see Table 2). Under the CBO's pessimistic forecast, the deficit falls from 5.4% of GDP in fiscal 1993 to 2.7% in 1997. Under the Administration's forecast, the deficit falls even further—to 2.2% of GDP in fiscal 1997—because of the higher level of GDP that is attained and the increased tax revenues and reduced mandatory expenditures that accompany a healthier economy.

Finally, a credible plan requires an enforcement mechanism. Under the President's plan, we propose to extend the Budget Enforcement Act, with continued caps on discretionary spending, "pay-as-you-go" requirements, and sequesters when necessary.

The President's plan is a bold one, but of course it is only the beginning of a long budget process. We welcome your ideas about how to improve this package. While no one will be happy with everything in this package, let me underscore the President's view that our deficit reduction goals will never be attained unless we are willing to view these hundreds of specific proposals as a single package. If we are going to restore a proposed spending cut, we must propose specific alternatives to take its place. If we do not hold ourselves to some rule, then we will not serve the taxpayers and voters of this Nation well.

If the Congress enacts this deficit reduction plan, the results will be dramatic. But the reality is that deficits will begin to climb back up toward the end of the decade. The primary reason is skyrocketing health care costs. As a government and as a society, we must reform health care to ensure quality, affordable care for all Americans. Health care costs threaten the security of families, businesses, and government alike. We must also act to control health care costs if we hope to control deficits in the long term.

How the Package Promotes Fairness

All three elements of the package will help restore a sense of fairness. The stimulus will promote job opportunities for some of the 9 million unemployed members of our labor force. Since the investment program includes a number of programs, such as head start, WIC, health care, worker training and retraining, education and the earned income tax credit, that directly increase opportunities for the most disadvantaged members of society, it will also help level the playing field. Finally, the manner in which revenues are raised for deficit reduction will ask the most from those who can afford it—the top 1.2 percent of American income earners. All of these features of the total package will help restore a sense of fairness in our system and give meaning to the American dream for those members of society who were left behind by the policies of the past twelve years.

The Economic Outlook

Forecasting economic performance is not an easy task. As the budget process reminds us, there are many uncertainties which will have a great impact on the future path of the economy. What is more important than any specific predictions CBO or the Administration make about economic performance is that we make sound choices about policy that raise the our investment rate, our productivity, and ultimately, our living standards.

As noted in discussing the budget estimates, the Administration forecast for real GDP growth is slightly higher than the CBO forecast on balance. In 1993 and 1994, the Administration forecast of 3.1 and 3.3 percent growth, respectively, corresponds exactly to the private Blue Chip consensus forecast. This is higher than the CBO estimates of 2.8 and 3.0 percent. The Administration forecast assumes that the stimulus package provides some additional growth in real GDP in the early years. As the stimulus wears off and the ITC for large

businesses is eliminated, the Administration forecast is actually below the CBO forecast in 1995.

From 1996 through 1998, the Administration forecast essentially assumes that the economy begins to feel some of the benefits of a higher capital stock as a result of the investment program and the tax incentives provided in the stimulus. Consequently, while the CBO assumes that growth falls off to less than 2 percent by 1998, we feel that a rate of 2.5 percent is more realistic. In these "out years," the Administration forecast is identical to the Blue Chip consensus.

Mr. Chairman, this concludes my testimony for this morning, but I wanted to take a moment to thank you and your committee for your invitation and for your welcome. I look forward to working with you during my tenure at the Council of Economic Advisers. I know by working together we can all share in the effort to strengthen our economy by ensuring a stronger recovery, higher rates of public and private investment, and smaller Federal budget deficits.

Table 1. Comprehensive Budget Impact of the Package

	FY1997
BASELINE	$346
Spending Cuts:	-37
Nondefense discretionary	-20
Entitlement	-41
Associated debt service	-14
Subtotal:	-112
Revenue Increases	-83
GROSS DEFICIT REDUCTION	-195
Clinton investment program:	
Spending	+39
Tax reductions	+15
Subtotal:	+55
NET DEFICIT REDUCTION	-140
DEFICIT WITH CLINTON POLICY	$206

Notes: This scores savings generated by increasing the taxation of social security benefits as a cut in entitlement. Some may prefer to count it as a tax increase.

Table 2. Comparison of Real GDP

	1993	1994	1995	1996	1997	1998
CBO	2.8	3.0	2.8	2.6	2.2	1.8
Administration	3.1	3.3	2.7	2.5	2.5	2.5
Blue Chip	3.1	3.3	2.5	2.5	2.5	2.5

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